ONTARIO

DEPARTMENT OF FINANCIAL AND COMMERCIAL AFFAIRS

[Committee]

REPORT OF THE COMMITTEE OF THE ONTARIO SECURITIES COMMISSION ON THE PROBLEMS OF DISCLOSURE RAISED FOR INVESTORS BY BUSINESS COMBINATIONS AND PRIVATE PLACEMENTS

Issued by the
ONTARIO SECURITIES COMMISSION
555 YONGE STREET, TORONTO 284, ONT.

February 1970

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PROVINCE OF ONTARIO

DEPARTMENT OF FINANCIAL AND COMMERCIAL AFFAIRS

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February 1970

Excerpt taken from the Minutes of the Ontario Securities Commission recorded April 17th, 1969

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RESOLUTION

WHEREAS The Honourable H.L. Rowntree, Q.C., the Minister of Financial and Commercial Affairs, by letter dated April 14th, 1969, a copy of which is appended hereto as Appendix "A", requested the Commission to undertake a study of,

(a) the present legislation and regulations relating to consolidations, amalgamations, mergers, re-organizations and takeovers;

(b) the problems raised by conglomerates, and

(c) private placements and exempt purchasers.

BE IT THEREFORE RESOLVED that the following committee be appointed,

H. S. Bray, Q.C.
Professor J. Willis, and
D. S. Beatty,

with the following terms of reference:

(1) in the light of present practices and conditions, to review and report upon existing legislation, regulations and policy relating to consolidations, amalgamations, mergers, re-organizations, takeovers, private placements and exempt purchasers, and related subjects, and generally to recommend what, if any, changes in the law appear desirable;

(2) to review and compare the legal and business situations in other jurisdictions in Canada and the United States;

(3) to invite submissions from informed members of the public and the corporate and financial community; and

(4) to assist in the study the Committee may retain the services of Professor David Johnston as counsel and the services of such additional research and stenographic staff as may from time to time be required, within the limits of the research budget available.

The Committee is requested to proceed immediately with its study with a view to reporting its findings not later than the end of this year. The funds for the Committee's study are to be provided from that part of the main office research vote for 1969-1970 for Commission research projects.

TORONTO, April 17th, 1969. "

Appendix "A" referred to
in O.S.C. Minutes dated
April 17th, 1969.

ONTARIO

Minister of Financial and Commercial Affairs

April 14, 1969

Dear Mr. Langford:

You and I have discussed the desirability of a study by the Ontario Securities Commission dealing with present legislation and regulations relating to consolidations, amalgamations, merger or re-organization and take-overs. This will, of course, lead to consideration of the problems raised by conglomerates, and also deal with private placements and exempt purchasers.

It is my wish that the Commission proceed with a study of this nature in the course of which a review might be made of the situation existing in comparable jurisdictions in Canada and the United States. You would, no doubt, want to review such matters which have come before the Commission involving, as some do, the purchase of shares of a company for cash and in others where the consideration involves the exchange of securities. I would expect that the study would review the possibility that transactions of this nature could lead to undesirable debt structure and also that such transactions could provide an opportunity for market manipulation whether or not an acquisition were successful.

My own view is that a present member of the Commission should be in charge and the size of the committee should be not so small that it has a narrow approach to the subject, nor so large that it is unwieldy in achieving its objective.

With respect to the study group and staff, I appreciate that you may want to use the service of persons such as Professor David Johnston and it may well be that suitable students might be available to do some of the work during the coming vacation. With respect to the study group itself, you may wish to supplement your Commission staff by the addition of a member of the public or one of the university schools of business and administration and I can appreciate the desirability of this. Mrs. Dagmar Stafl of our own Department might also be of assistance to you.

I am constantly being reminded of the money situation and I would ask that you keep this factor in mind in making the original arrangements and commitments. The

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Deputy Minister will be in a position to assist you in this aspect.

In the course of the study, I would assume that the committee will want to meet with informed members of the public and the industry, who from their experience might be able to make a contribution to the study. I am quite sure that knowledgeable persons in the financial and corporate community would be willing to express their views.

I would hope that the matter might be concluded not later than the end of the year.

Yours very truly,

"H. L. Rowntree"

H.L. Rowntree,
Minister.

H. E. Langford, Esq.,
Chairman,
Ontario Securities Commission,
Department of Financial and
Commercial Affairs,
123 Edward Street,
Toronto 2, Ontario.

P R E F A C E

Before we embark on the substance of this study we should like to pay tribute to the many individuals and organizations without whose help it would have been impossible to undertake the study let alone attempt its completion within the span of time allotted to us. The twin cornerstones were laid when we obtained the talents, energy and enthusiasm of David L. Johnston, Associate Professor on the Faculty of Law of the University of Toronto as our counsel, and Peter Dey as our research director. The Toronto legal firm of Osler, Hoskin & Harcourt solved a pressing problem for us when they granted Mr. Dey a leave of absence to enable him to join us in the study. For this we most sincerely thank them. These are but two examples of how the public can be served through a combination of the public, the private and the academic sectors of the community.

The accounting for business combinations obviously played a most important part in our deliberations. Indeed we devote a separate chapter to it. It may be observed that neither the Committee itself nor any member of its study staff makes any pretensions to expertise in the accounting field. As a result of discussions with the Ontario Institute of Chartered Accountants they volunteered to form and did form what we have called the "ad hoc" accounting committee consisting of G. Kenneth Carr, F.C.A. of Clarkson, Gordon & Co., who acted as the committee chairman, Ralph Fisher, C.A. of Laventhol, Krekstein, Horwath & Horwath, P. Howard Lyons, F.C.A. of Deloitte, Plender, Haskins & Sells (who also provided the contact with the Research Committee of the Canadian Institute of Chartered Accountants) and St. Elmo V. Smith,

F.C.A. of Price, Waterhouse & Co. The members of this committee, individually and collectively, gave us positive guidance throughout. They have reviewed our draft conclusions in the accounting chapter and as a result have enabled us to avoid what we are sure would be considered by the accounting profession as fundamental mistakes. Again our sincere thanks to this volunteer group of consultants.

Through Mr. Lyons and others we were aware almost from the outset of the joint study established by the Canadian Institute of Chartered Accountants and the University of Western Ontario School of Business into the problems raised in the methods of accounting for business acquisitions. This we believe has been the most sophisticated study of its kind in Canada. Indeed it is unique. We are indebted for the co-operation of both the Canadian Institute and the authors of the study who were kind enough to press it to a conclusion in order that its results should be made available to us for the purposes of this report. Consequently we have relied in this important area on the findings of the Joint Study. We have made use of it and have relied upon its recommendations in our conclusions concerning accounting.

The staff assembled and other help in sight, our first collective task after defining the scope of the study was to immerse ourselves so that we could determine the nature and extent of the problem we were considering. With the United States Securities and Exchange Commission's recently concluded study on securities disclosure at hand we were afforded every courtesy by its new Chairman, the Honourable Hamer L. Budge, its Chief Accountant, Andrew Barr, and Associate Chief Accountant, Lindsey J. Millard, and many other senior members of its staff. While we were able to

meet briefly with Commissioner Francis M. Wheat, the author of the report, his resignation from the S.E.C. shortly after the commencement of our study prevented fruitful discussion. The Wheat Report, of course, has been carefully considered by us.

A close rapport has existed for many years between the various Canadian provincial securities administrators. Their comments are always helpful. Unfortunately the assistance given by two of the most senior of them, Mr. G.H. Rose, Q.C., the Chairman of the Alberta Securities Commission, and Mr. W. S. Irwin, the British Columbia Superintendent of Brokers, was limited to some extent by the fact that they were then actively engaged as members of the Canadian Committee on Mutual Funds and Investment Contracts whose definitive report on this subject was released on December 9th, 1969. This notwithstanding they found time to offer us guidance. In addition we would like to make particular mention of the very helpful replies we received from Murray Peden, Q.C., Chairman of the Manitoba Securities Commission and his staff, Marcel Lajeunesse, Q.C., the Chairman of the Quebec Securities Commission, and Mr. I.A. Richards, Registrar, Securities Act, of Newfoundland.

We requested assistance and comment from something over 400 individuals whose names were known to us or referred to us as being actively engaged in those fields of business, finance, law and accounting touching in some fashion upon the subjects with which we were concerned. We requested briefs from approximately 40 associations and organizations who directly or peripherally had an interest in the topics under discussion. In many cases where time and distance permitted, our requests having been made from coast to coast across

Canada, some of us were able to engage in discussions with the contributors. We commenced to review and analyse what proved to be extensive literature on the various subjects. As a starting point for those who wish to examine the topics further we have attached hereto as Appendix I a partial bibliography. Our reading and the preliminary comments we had received enabled us to prepare what we called the "Expanded List of Topics" which we have attached hereto as Appendix II. This was published in our Weekly Summary for August 1st, 1969 along with a general invitation for submissions.

We had been asked to attempt to conclude our study by December 31st, 1969. With this schedule we felt that public hearings were not practicable. However we had invited submissions through our Weekly Summary from the public generally. We were both stimulated and encouraged by the quality and candour of the submissions and comments made to us. While a number of contributors have requested that they not be identified we have listed in Appendix III those who placed no such restriction on us. Their briefs and written comments have been assembled, together with other research material, and lodged in the departmental library for the use of anyone who may find it of interest.

The total experience has been a most heartening one for both the members of the committee and its staff. One cannot speak too highly of the helpful and constructive manner in which suggestions were brought forward. The public not only of Ontario but indeed the whole of Canada continue to be well served through what in fact is voluntary public service by individuals who are extremely competent in their chosen professions.

There are numbers of others whose names have not been specifically mentioned either here or in the list of contributors, to whom we are indebted. Mrs. Dagmar Stafl, the Departmental Economist, was an active participant in many of our discussions in addition to preparing the economic paper referred to in the first chapter. Miss Helena Beran and Miss Alison Hegarty were responsible for much of the empirical research, having brought with them the experience gained on the Canadian Committee on Mutual Funds Study. Miss Mary Grenier came to us as the secretary for the study but her cheerful competence was such that she soon relieved Messrs. Johnston and Dey of those matters involving organization and office administration. She produced the numerous copies of material, including drafts of this report, with accuracy and dispatch. In these labours she was joined by Mrs. Marlene Wolfer, whose pleasant disposition and seemingly unflustered efficiency remained at a consistently high level notwithstanding the fact that this burden was added to her normal duties as secretary to the Vice-Chairman. We are deeply indebted to all of them.

H. S. Bray, Q.C.,

D. S. Beatty,

J. Willis, Q.C.

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CHAPTER 1

INTRODUCTION

Background of the Study

1.01 Ontario's revised and expanded securities legislation came fully into force on May 1st, 1967[1]. In its innovations it closely followed the recommendations made in the Report of the Attorney General's Committee on Securities Legislation in Ontario[2]. For the first time the legislation recognized through its expanded and continuing disclosure requirements the need of investors for continuing adequate information concerning the issuers whose securities are being traded by the public in Ontario.

1.02 In the months which followed the Commission and its staff, both newly reorganized and enlarged, were largely engaged by the problems of administration. Some deficiencies were recognized and catered for through amendments to the Act and the regulations. This study, prompted as it was by the accelerating use of business combinations and the potential for abuse through public distribution of securities in the guise of private or exempt placements, represents an in depth examination of the effectiveness of the present legislative policy.

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1 Stats. Ont. 1966, c.142, as am. by 1967, c. 92, 1968, c.123, and The Securities Amendment Act, 1968-69, the latter being only partly in force at present, hereinafter referred to as "the Act".

2 Report of the Attorney General's Committee on Securities Legislation in Ontario, March 11, 1965, Toronto, hereinafter referred to as "The Kimber Report".

Business Combinations

1.03 Public attention has been directed both in Canada and the United States to the questions of corporate disclosure raised by the urge to merge. Over and above those take-overs attempted through the provisions of Part IX of the Act there were other forms of business combinations brought to the Commission's attention which attracted little public concern but which raised equally important questions. In addition there were private agreements, statutory amalgamations, re-organizations, asset purchases, and other methods of materially adding to or combining with an existing business. These combinations, including acquisitions, may be achieved through share exchanges or for other consideration.

1.04 While this study did not have as its object economic planning we were mindful that the facts would be of interest to others[3]. Among the business reasons for acquisitions and other combinations are expansion of capital, markets and product lines and increased efficiency. Another is the pressure to show continued profits.

1.05 The surge of acquisitions which underlined the necessity for their study is shown by the following statistics[4]:

Year	Number of Acquisitions
1960	203
1961	238
1962	186
1963	133
1964	196
1965	229
1966	227
1967	246
1968	389

3 See Appendix IV.

4 Report of the Director of Investigation and Research, Combines Investigation Act, for year ended March 31, 1969, at p.31; Queen's Printer, Ottawa. Firms in the service sectors of the economy except for transportation are largely excluded.

1.06 A report entitled Business Combinations in the '60s: A Canadian Profile undertaken by The Canadian Institute of Chartered Accountants and The School of Business Administration of The University of Western Ontario recently published[5] shows a similar trend for industrial companies whose securities are listed on The Toronto Stock Exchange. About 33% of the 998 acquisitions reviewed for the years 1960 to 1969 occurred in 1967 and 1968. The same trend was apparent in the United States[6].

1.07 The financing of acquisitions in Canada differs from the United States. The majority of acquisitions in Canada, because of tax laws, are financed by issuing equity securities or for cash. Debt securities are not popular here because the cost of such funds is not a deductible expense when used to acquire shares. The Joint Study reported that 51% of the acquisitions reviewed, in dollar amount of the purchase price, were effected by issuing common stock as compared to 36% from working capital, 9% through preferred stock and only 4% by long term debt[7]. In the United States the interest on funds borrowed to effect acquisitions is deductible for tax purposes and thus debt securities are more commonly used to finance acquisitions. As a consequence there is cause for the concern in the United States that acquisition minded companies are assuming an oppressive debt structure. While one must always be mindful of it the potential problem is not so likely in Canada.

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5 Business Combinations in the '60s: A Canadian Profile by Samuel A. Martin, Stanley N. Laiken and Douglas F. Haslam, published jointly by The Canadian Institute of Chartered Accountants and The School of Business Administration, The University of Western Ontario, London, February 1970, hereinafter referred to as the "Joint Study". See Chart III-1 at p.15.

6 Appendix IV at p. 3.

7 Joint Study, Table III-2 at p. 19.

1.08 With the floodlight of publicity has come a new word, "conglomerate", frequently used to describe acquisition minded companies which through acquisitions have interests in a number of unrelated kinds of business. These frequently are what were previously known as closed-end investment companies. A number of well-known Canadian corporations would today be styled "conglomerates" along with those corporations whose new names or new images coupled with their appetite for acquisition have attracted attention.

1.09 Whether the acquisition minded company is a conglomerate or is embarked on a program of vertical or horizontal integration the same problems of investor disclosure arise. It was for this reason that the short title of "Merger Study" was adopted. A prospectus standard of disclosure is only required by Part IX of the Act for a share exchange take-over bid[8]. In other cases an exemption is generally available under the Act or upon application to the Commission. The chapters which follow deal with each area.

1.10 There is constant pressure upon management for market performance. In the case of the acquisition minded company the cost of the acquisition will be less as the market price of the securities used to finance it increases. The equity of the remaining shareholders will thus be less diluted. The market price of the securities will normally rise if the issuer reports higher earnings per share. The fact that the method of accounting for an acquisition will lead to reporting different levels of earnings is not always appreciated by the investor[9].

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8 Section 94 of the Act.

9 See Chapter IX. A reported increase in earnings may result from the method of financial presentation and not from the generation of internal profit or growth.

1.11 While some attention has been given in Canada to the characteristics of the securities used to finance acquisitions the problem has been more acute in the United States. Debt financing, because of taxation, was more acceptable. The cost of such financing became so prohibitive that financial advisers felt it necessary to attach some form of equity privilege to the debt security so as to make it saleable. So exotic have these permutations and combinations of securities become that they have become known as "Chinese money" which underlines the difficulty of the investor in assessing their value[9a]. We concur in the conclusions of the Joint Study in this regard which states:

> "Our inspection of the specific features of the debt and preferred securities that were issued revealed that there was not a frequent use of convertible securities or other instruments with sophisticated preference features. Such issues have been the object of criticism and debate in some acquisition transactions in the United States." 10

1.12 We have been concerned as to the adequacy of the information disclosed both before and after acquisitions. The investor's decision is frequently based on financial disclosure. This is dependent upon the method of accounting. The Joint Study concluded that these accounting principles are urgent matters to which the Canadian Institute of Chartered Accountants should direct its attention. It states in support of this conclusion:

> "It has been argued that the accounting treatment used in mergers has had a direct influence on the number of merger transactions and therefore the vitality of our economy and the growth of specific industries or sectors within the economy." 11

9a For instance see "'Chinese Money' Tends to Confuse Investors", by Fraser Robertson, Globe and Mail, March 11, 1969, p. B-2.

10 Joint Study <u>op</u>. <u>cit</u>. at p. 20.

11 <u>Id</u>. at p. 49.

The flow of capital must depend on the certainty with which the investor is able to act.

Private Placements

1.13 There are two kinds of private placement exemptions from the prospectus requirements. These are purchases by certain exempt institutions and persons, and sales of a minimum size[12]. They permit the sale of new issues to classes of sophisticated purchasers. The importance of these exemptions has grown. Since the exemption flowing from section 19(3) of the Act is relatively new, meaningful statistics are sparse. However between July 1st, 1968 and August 31st, 1969 companies listed on the Toronto Stock Exchange took advantage of these combined exemptions to make 48 private placements to a value of $141,000,000 [13]. Both the issuers and the investment community are enthusiastic about the speed and relatively inexpensive nature of this route for raising funds. The Committee, for their part, were concerned about the adequacy of the disclosure available to investors at the time of the resale of the securities to the general public.

1.14 The present legislation provides for no special public disclosure. The Exchange has some limited control. Investors may not be in a position to assess the dilution of their investment nor to assess the changes which have resulted through the use of the funds raised privately. The increase in the use of these exemptions gives credence to the suggestion that the stringency of the prospectus requirements makes the private placement route so attractive

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12 See Chapter V - Private Placements.

13 Further statistics will be found in Appendix V.

for the issuer that as a result the general public may seldom have the opportunity of purchasing sought after issues at the initial offering price[14]. This is not a result to be desired.

1.15 While we have not yet achieved the sophistication of "letter" stock we appeared to be moving in this direction as the result of the variety of opinions available as to the rights of resale of these purchasers, particularly those who have declared their investment intent. The liberality of some views and the lack of any noticeable restraint for the recipients under other classes of exemption gave concern as to the adequacy of disclosure to investors generally.

Scope of the Study

1.16 These and other matters had been the subject of discussion between the Minister of Financial and Commercial Affairs, the Honourable H. Leslie Rowntree, Q.C., and the Chairman of the Commission, Henry E. Langford, Q.C. As a result of the request made by the Minister in his letter of April 14th, 1969, the Commission met on April 17th and appointed three of its members to undertake the study[15]. The basic terms of reference set out in the Resolution were:

> "In the light of present practices and conditions, to review and report upon existing legislation, regulations and policy relating to consolidations, amalgamations, mergers, reorganizations, take-overs, private placements and exempt purchasers, and related subjects, and generally to recommend what, if any, changes in the law appear desirable..."

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14 See "Corporate Finance" by J.C. Baillie at p. 120 in Developments in Company Law, Law Society of Upper Canada Special Lectures, 1968, De Boo, Toronto, Ontario.

15 The Minister's letter and the Commission Resolution are reproduced as a frontispiece to this Report.

1.17 Resisting the temptation to dwell in areas outside of our prime concern we turned our attention to investor protection through adequate disclosure concerning the affairs of the issuer. While appreciating the constitutional questions which have resulted in the division, in the areas of regular corporate disclosure and insider liability, of such disclosure between the Ontario Corporations Act for Ontario companies and the Securities Act for all others, the division does tend to detract from the principle that there should be an equality of information for all investors, whether shareholders or not, as to the affairs of issuers whose securities are publicly traded.

1.18 In order to examine the questions we found it necessary to consider the fundamental definition underlying the disclosure requirements of the Act, "primary distribution to the public"[16]. But in order to decide who the "public" are that the legislation seeks to inform and to protect it was first necessary to examine the principle of disclosure[17].

<u>Disclosure and Investor Protection: The Legislative Philosophy</u>

1.19 The obvious purpose of all securities legislation is to provide some measure of protection for the investor. In our society, while the relative weight to be given to each may vary in the light of existing conditions, this protection is given to the investor in such fashion as to balance his rights and the obligations of the issuer so as to permit the capital markets to function with maximum utility. The Kimber Committee directed their attention to this question and concluded that some form of continuing disclosure was the most

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16 Section 1(1)16 of the Act. See Chapter III.

17 See Chapter II.

effective means of achieving and maintaining a high level of investor confidence in the capital markets in Canada[18].

1.20 We are in complete agreement with this conclusion. In stating this we emphasize that by permitting the sale of particular securities the securities administrator does not guarantee the success of the venture nor the ultimate honesty of anyone associated with it. The decision to purchase or sell rests with the individual. The role of the legislation and the philosophy of those charged with its administration must be to lend every effort to ensuring that adequate information disclosed quickly enough to be useful is available to the investor and to those upon whom he is entitled to rely for investment advice. With the implementation of the Kimber Report the emphasis shifted from the particular issue being sold to continuing information concerning the issuer.

1.21 In its Securities Act of 1933[19] and the Securities and Exchange Act of 1934[20] the United States adopted the principle of truth in disclosure. In its recently published report concerning Disclosure to Investors a committee headed by then Commissioner Francis M. Wheat of the Securities and Exchange Commission examined and reappraised S.E.C. administrative policies[21]. This report recommended a further movement away from what we call prospectus disclosure in favour of a revised and expanded continuing disclosure system.

1.22 We have advanced more closely to a continuing disclosure system than perhaps the public generally realize.

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18 Kimber Report, *op. cit.* footnote 2, Part IV.

19 48 Stat. 74(1933), hereinafter called the '33 Act.

20 48 Stat. 88(1934), hereinafter called the '34 Act.

21 Disclosure to Investors, A Reappraisal of Administrative Policies under the '33 and '34 Acts, Securities and Exchange Commission, Washington, March 1969.

This process may have been aided by the uncertainty, in the absence of experience, as to the nature and extent to which our courts will go in interpreting the existing insider liability, as well as other trends encouraging such disclosure. There have been at least two positive advances. Firstly the Toronto Stock Exchange has implemented a requirement for quarterly financial reports for many listed companies[22]. Secondly both the Exchange and the Commission promulgated "timely disclosure" policies in October, 1968 encouraging issuers to announce significant and material events which might assist investors in reaching an informed decision[23]. The results have been most encouraging and responsible managements seek to comply with the spirit of these policies.

1.23 The Committee has concluded that this evolution should be completed. Current information should be available to investors at all time. This will provide the basis for an integrated and consistent system which will cater for the needs of investors when business combinations occur, when securities are made available to exempt purchasers or through private placements and through the existing exemptions. This is explored in detail in the chapters which follow.

1.24 In order that there should be consistency we have measured the problem raised against the need for information for particular investors at particular points in time. Our Act, as evidenced by the blanket prohibition contained in section 35 against primary distribution to the public before a suitable prospectus has been accepted for

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22 The Toronto Stock Exchange Policy for the Reporting of Quarterly Statements, December 9, 1968.

23 Corporate Guide to the Timely Disclosure Policy of the Toronto Stock Exchange, October 4, 1968 and Ontario Securities Commission Weekly Summary for the week ending September 27, 1968.

filing, appears to assume that everyone needs information during the course of such a distribution. Section 58, largely by referring to specific exemptions in section 19, then goes on to exempt trading in a variety of circumstances or of particular kinds of securities from this mandatory prospectus requirement.

1.25 We have been urged not to place undue weight on the experience of our American neighbours, particularly because of the disparity in the relative size of our markets and the consequent differences in liquidity. Unquestionably our market place has developed along parallel lines to that in the United States. Certainly the Kimber Report drew heavily upon both their experience and their techniques.

1.26 We have applied this "need to know" test throughout our consideration. It was authoritatively recognized by Justice Clark of the United States Supreme Court in S.E.C. v. Ralston Purina Co.[24] when he stated:

> "The focus of inquiry should be on the need of the offerees for the protections afforded by registration (a prospectus)."

Outline of the Report

1.27 In Chapter II we will examine this principle of disclosure. Chapter III deals with the broad question as to who are the "public", who needs to know and under what circumstances. The report moves on in Chapter IV to the position of "control persons". The subject of exempt purchasers and private placements is dealt with in Chapter V under the general heading, "private placements". The exemption contained now in section 19(1)9 of the Act in connection with "a consolidation, amalgamation, merger or re-organization" is discussed in Chapter VI under the topic

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24 346 U.S. 119 (1953).

"business combinations". "Take-over bids" are the subject of our concern in Chapter VII. In order to integrate and cater for the balance of the exemptions provided for in sub-sections 1 and 2 of section 58 of the Act we review these in Chapter VIII. Accounting, underlying the whole, completes our substantive study in Chapter IX. For convenience Chapter X draws together all of our recommendations.

Importance of Liquidity to Canadian Capital Markets

1.28 Throughout our discussions we were made acutely aware of the problems of liquidity in our capital markets and the limited range of Canadian equity securities available to Canadian investors. This was carefully reviewed by Professor G.R. Conway in a study concluded for the Toronto Stock Exchange in which he forecasted that "the total average annual demand for additional equities in Canada in the immediate years ahead is likely to be almost double the supply provided through net new Canadian issues"[25].

1.29 It is important, consistent with investor protection, that the regulatory framework should not impede either the flow of capital or the widest distribution of securities. In reaching conclusions we have made recommendations, based upon the cornerstone of adequate continuing disclosure, which will not inhibit the issuer in his approach to all classes of investor or unduly restrict the resale of those securities once issued.

Limitations of the Study

1.30 Before embarking upon our research we felt it

25 The Supply of, and Demand for, Canadian Equities, A "Conspectus", September 1968, the study commissioned from the Faculty of Administrative Studies, York University, Toronto, by the Toronto Stock Exchange and prepared by Professor G.R. Conway, at p.42.

important to delineate those areas we had no mandate to consider. Patently, in the fashion described in the preceding paragraph, we had to be mindful of the impact of securities regulation upon the economy. With some difficulty the temptation to linger in the broader areas, including foreign ownership, was avoided. Neither the Committee itself nor its staff are capable of making judgments involving economic planning. Apart from establishing contact we leave these larger issues to those experts in our Department of Treasury and Economics and others who may be charged with such responsibility.

1.31 We have referred previously to the paper prepared by our Departmental Economist[26]. It is noted with interest that the economics of business acquisitions have been the subject of a recent study by the Economic Council of Canada[27]. The economic implications of mergers in the United States were the subject of a recent staff report to the Federal Trade Commission[28].

1.32 While "conglomerates" are swallowed up in the broader subjects of business combinations and take-over bids, this report is directed to the protection of the investor and not to the equally interesting questions involving the rights and obligations of investors who become shareholders which have engaged the attention of the Select Committee on Company Law[29] and which, as to further aspects, still engages

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26 Supra footnote 3 and Appendix IV.

27 Interim Report on Competition Policy, July 1969, Economic Council of Canada, Queen's Printer, Ottawa.

28 Economic Report on Corporate Mergers - Staff Report to Federal Trade Commission, U.S. Government Printing Office, Washington , 1969.

29 1967 Interim Report of the Select Committee on Company Law, Legislative Assembly, Ontario.

the attention of a similar committee[30].

Uniformity

1.33 While the Committee have formulated recommendations which are administratively feasible and capable of implementation within a reasonable time, we are conscious of the substantial uniformity which now exists in Canada. At present British Columbia, Alberta, Saskatchewan, Manitoba and Ontario have adopted similar legislation. Both Quebec and New Brunswick have indicated that they will be adopting the uniform approach in the foreseeable future. We view the maintenance of uniformity of administration of great importance.

1.34 Our short term recommendations have been formulated in the hope that they may meet with general approval. As to the long term recommendations they will be the subject of considerable discussion before the details are agreed upon once the principles are settled.

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30 Select Committee on Company Law, under the chairmanship of Gordon R. Carton, Q.C., M.L.A.

CHAPTER II

THE PRINCIPLE OF DISCLOSURE

The Purpose of Disclosure

2.01 The principle of "full, true and plain disclosure of all material facts relating to the securities offered" for the first time to the public has been a cornerstone technique of investor protection in Canada, the United States and the United Kingdom throughout most of this century[31]. As we shall note in our consideration of the evolution of disclosure the principle of continuing disclosure as an instrument of protection was added in Ontario following the Kimber Report. To this has been added the "timely disclosure" policies of the Exchange and the Commission. The purpose of the whole is to provide an equality of opportunity for all investors in the market place, sellers as well as buyers. The object is to make available on a timely basis all material facts the investor requires to make an informed investment judgment.

2.02 Disclosure thus implements the broad objective of securities regulation: to create and maintain public confidence in Canadian capital markets. Adequate disclosure establishes the information base from which investment decisions can be made. Perhaps more importantly from these facts investment advice can be developed by the investment community for the general public. Furthermore if securities are evaluated on the basis of complete and current information the pricing mechanisms of the capital markets operate in a

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31 This language continues to be enshrined in the Act in the certificate required on each prospectus by section 52(1). It is also fundamental to the liability created by section 141.

more rational and accurate fashion. The public can trade with greater confidence if equality of information is implicit in securities regulation.

2.03 The importance of adequate disclosure has been emphasized through a number of commissions and studies. In addition to the Kimber Report, there are the comments of Mr. Justice Kelly concerning the adequacy of disclosure as the result of his investigation into the circumstances surrounding the trading in shares of Windfall Oils and Mines Limited[32] and more recently the conclusions of Mr. Justice Hughes following upon his examination of the affairs of Atlantic Acceptance Corporation Limited and related matters[33]. Our enquiries lead us to conclude that the management of most public companies are not only responsible but also responsive to this demand for disclosure. Those few who are not should be prepared to respond and account for their failure.

2.04 While examining the purpose of disclosure it may be viewed as timely and not inappropriate to introduce without further comment as a counterpoint to these discussions the eloquent but pragmatic conclusion of Mr. Justice Hughes. He stated, in part:

> " I have endeavoured, in the specific recommendations made in this concluding chapter, to suggest changes and safeguards in legislation, and by way of regulation, which will, if adopted, I hope make a repetition of the Atlantic disaster more difficult, coming as it did like a sudden and violent storm out of a cloudless sky in a season of prosperity. After the storm many prospects were found to have darkened, and the wreckage left in its wake may still be discerned. There can be no guarantee that such a convulsion will not occur occur again, whatever legislation may be enacted or regulatory policy devised, because

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32 Report of the Royal Commission to Investigate Trading in the Shares of Windfall Oils and Mines Limited ("Kelly Report"); Queen's Printer, Toronto, 1965.

33 Report of the Royal Commission to Inquire into the Failure of Atlantic Acceptance Corporation Limited ("Hughes Report"); Queen's Printer, Toronto, 1969.

it had its origins in fraud and concealment, and it is yet to be demonstrated that laws of general application can be wholly successful in providing against the resolve of any human agency to twist and break them...." 34

The Evolution of Disclosure

2.05 Ontario's Securities Frauds Prevention Act of 1928[35] borrowed heavily from the experience of the United Kingdom. It was not until after 1933 and 1934 that the United States enacted what was to become a comprehensive federal regulatory scheme[36]. While, as we previously noted[37], our legislation appears to reflect the '33 Act disclosure philosophy in its application of a "need to know" standard in framing exemptions, this does not appear to be the result of conscious imitation but rather logical development. Although strongly disclosure oriented, through provisions such as section 61 of the Act the Ontario legislation provides a residual discretion. This affords the Commission the opportunity of offering guidance through policy statements as to the circumstances under which this discretion may be exercised. When coupled with a provision for written reasons in specific cases[38] where that discretion is exercised this avoids any tendency to administer through delay which may be present in a less flexible system.

2.06 Until 1964 the major emphasis in U.S. federal legislation was placed on the '33 Act which governs prospectus disclosure in those circumstances which broadly speaking would be viewed as primary distribution to the public in

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34 Id. at p.1677.

35 Stats. Ont. 1928, c.34.

36 Op. cit. footnotes 19 and 20.

37 Supra p.13, para. 1.24 et seq.

38 Section 61(2) and section 5.5 of the Act.

Ontario. The '34 Act, directed as it was to stock exchanges and the listed market, concerned itself until 1964 with continuing disclosure relating to the affairs of the issuer of listed securities. In that year the '34 Act was applied to unlisted securities as well. Thus timely disclosure of material information evolved in a chequered manner through the '34 Act[39]. In March, 1969 the Wheat Report was published. This examined the disclosure techniques in use by the Securities and Exchange Commission and concluded with specific recommendations aimed at the rationalization and integration of the disclosure requirements of the '33 and '34 Acts. Draft proposals to implement some of the Wheat recommendations have since been released[40].

2.07 The addition of continuing disclosure to the prospectus disclosure previously available commenced on May 1st, 1967 in Ontario. On this date the new Act and its regulations, coupled with parallel requirements in the Ontario Corporations Act[41], implementing the Kimber Committee recommendations, came into force. The filing of a prospectus under which it was proposed to distribute equity securities or a listing on the Toronto Stock Exchange attracted the new

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39 S.E.C. Release No. 4991 under the '34 Act provided for Form 8-K in 1954 which requires disclosure of material events within 10 days of the end of the month in which they occur. S.E.C. Release No. 34-3230 promulgated Rule 10b-5 in 1942 pursuant to section 10(b) of the '34 Act which more indirectly requires timely disclosure of all information necessary to avoid deceit in the market place. Its use and scope, while not clearly defined, have been the subject of much discussion. See S.E.C. v. Texas Gulf Sulphur Co. 401 F.2d. 833 (2d. Circ. 1968).

40 S.E.C. Releases, September 15, 1969, 34-8680, 8681, 8682, 8683, 8684, 8685, 8686, 33-4996, 4997, 4998, 35-16460.

41 The Corporations Act, R.S.O. 1960, c.71, with the Kimber amendments found in 1966, c.28, and subsequent clarification in 1968, c.19, and The Corporations Amendment Act 1968-69 (as yet not assigned a chapter number).

continuing disclosure requirements to the issuer. The prospectus itself was to be in narrative form and detailed instructions were provided in the regulations. Parts X, XI and XII of the Act coupled with the regulations and the amended Ontario Corporations Act and its regulations described the method, time and detail of the disclosure required.

Continuing Disclosure in Ontario - Today

2.08 Apart altogether from the added or special disclosure requirements of the Toronto Stock Exchange companies subject to the requirements of the Act are now involved in several forms of continuing disclosure. Firstly, they must file with the Commission their audited annual financial statements containing at least the information required by the relevant acts and semi-annual unaudited statements also meeting minimum standards[42]. The information circular required to be sent annually to shareholders in Ontario and filed with the Commission provides additional narrative material. The annual reports and other information sent to shareholders in Ontario are filed with the Commission and become sources of investor information. Insider trading reports are viewed as significant. Added to these statutory requirements are the "timely disclosure" requirements of the Commission and the Exchange. Any disclosure resulting from a take-over bid is incidental to and not a part of this scheme of continuing investor disclosure. When the regulatory scheme is examined as a comprehensive whole it becomes apparent that we are extremely close to a continuing disclosure system approximating in total a prospectus standard of

42 Finance companies, in addition, are subject to special disclosure regulation. The T.S.E. requires quarterly financial statements from many listed companies with the declared intention that all should provide them in time.

disclosure.

2.09 This information is of little use as long as it remains buried in the Commission's files. The Commission has therefore sought to publicize its availability, on an equally timely basis, through noting the receipt of new reports in its weekly summary of activities published each Monday. The insider reports are collated and published, together with policies and decisions of more permanent interest, in the monthly Bulletin. We have been pleased to note the increasing use and dissemination of this information through the financial press, daily as well as weekly, and its use by the investment community. The circulation of the Bulletin has more than doubled during the past three years and is steadily expanding. At least one commercial service, presently providing a similar service in the United States, is engaged in determining the feasibility of a relatively inexpensive service for providing the information in our public files to interested persons.

2.10 The changes in financing patterns which led to this study had earlier caused the Commission and the Exchange to examine their positions regarding timely disclosure. Investors were frequently acting on inadequate or misleading information. The Exchange had the power to halt or suspend trading until such time as adequate information was made available and circulated. Through an amendment to the Act[43] the Commission was given the power to suspend trading. A co-ordinated study was embarked upon by the Exchange and the Commission and, as a result, in October 1968 both the Exchange and the Commission published "timely disclosure" policies which, if not adhered to, might result in the suspension of

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43 Section 141b added by Stats. Ont. 1968, c.123, s.40.

trading until proper information was made available to the investor. Both were aimed at requiring the timely disclosure by an issuer of information relating to changes or events of a material nature concerning the affairs of the issuer which should significantly affect investor decisions. The quarterly reports now required from approximately 70% of the Exchange's listed companies add another dimension.

Private Placement and Exempt Purchasers

2.11 The "need to know" philosophy was illustrated when section 19(1)3 was amended in 1963 to permit the Commission to recognize sophisticated investors as "exempt purchasers" and to provide an exemption from the prospectus requirements[44]. This exemption was continued forward in the present Act, sections 19(1)3 and 58(1). Through section 19(3) was added a different "need to know" test where sophistication was assumed from the size of the purchase and the organization of the purchaser rather than from an examination of the purchaser's qualifications[45]. In either case no information concerning the fact of the sale by the issuer, the reason for it or the names of the purchasers are matters of public record. A private placement report is required of the issuer under section 19(3) and the regulations and the purchaser is required to evidence an investment intent. The private placement reports are not in the public file. In the case of the sale to an institutional or exempt purchaser under section 19(1)3 neither the issuer nor the purchaser is

44 Sections 19(1)3 and 41, The Securities Act, R.S.O. 1960 c.363, as am. by Stats. Ont. 1962-63, c.131, s.10(1).

45 The aggregate acquisition cost to the purchaser must not be less than $97,000, and the purchase must be "for investment only and not with a view to resale or distribution" and the purchaser must not be an individual.

required to notify the Commission nor is there any real restriction on resale. The Exchange having continued control over the issuer through the listing agreement, does extract some disclosure and attempts some control of the resale[46]. The statutory exemptions do provide a route through which distributions may take place without any information being made available to the investor concerning the fact of the issue, the numbers, kinds and prices of the securities issued, and the purpose for which the securities are issued.

Market Information and Surveillance

2.12 Accurate reports of the actual prices at which trades have taken place and the volume of trading in particular securities are important pieces of investment information. They reflect the response of the market place to the facts known about the issuer. The reports act as a deterrent to market manipulation since they provide indices for the regulators engaged in market surveillance from which they will be put upon their enquiry to determine whether investors are responding on the basis of misleading or inadequate information or in response to accurate information. The investor may move with confidence knowing that his broker can complete the transaction fairly and at the best prices available. These are some of the advantages presently held by listed securities. In Toronto, the surveillance staff of the Exchange reacting to unusual change or activity responds quickly, requests and ensures that information is disseminated, and where necessary recommends the halting or suspension of trading until the existing facts are clarified. This is a far cry from the summer of 1964.

46 Toronto Stock Exchange: Notice to Members No. 580, February 14, 1969.

2.13 In his report of September, 1968[47] Commissioner D.S. Beatty expressed concern over the absence of any meaningful daily price and volume statistics for unlisted securities. The Report stated:

> "It is also proposed that a centralized agency be created to collect statistics on both unlisted mining and industrial stocks. These statistics would include market prices, record of transactions and volume and would improve the sources of information available to the public and to regulatory bodies governing the conduct of business on the over-the-counter market." 48

2.14 At this date the Investment Dealers Association of Canada (I.D.A.) has proposed a plan to the Commission which has been approved in principle. This has been the result of lengthy discussions between the Commission, in particular Commissioner Beatty, and the representatives of the self-regulatory bodies. The I.D.A. has undertaken to institute the plan and at the present time is close to instituting the initial phase of it. An amendment to the Act enables regulations to be passed in support of this information centre[49]. Through such a regulation all registrants may be required to report all unlisted trades to this unlisted trading centre. The I.D.A., of course, can require its own members to report. It is anticipated that the I.D.A. and the Commission will work together to provide an adequate level of surveillance.

Investor Disclosure

2.15 The Kimber Committee, in Part IX of its report,

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47 Report of Commissioner D.S. Beatty on Matters Related to the Financing of Mining Exploration and Development Companies, O.S.C., September 1968.

48 Id. at para. 1.08.

49 The Securities Amendment Act, 1968-69, section 10(1) adding to section 144 of the Act clause (da) providing for "regulating the trading of securities other than on a stock exchange recognized by the Commission".

were openly concerned about the constitutional implications of some of the provisions which they recommended. The federal and provincial corporations acts provided for some annual information to be provided to shareholders. It was inadequate for the purpose of investor protection. The American federal regulatory scheme, with its differences in responsibilities, catered for a form of investor disclosure through the proxy solicitation procedures. The result was the adaptation of the American scheme through amendments to the Ontario Corporations Act for Ontario companies with the provisions of The Securities Act, 1966, governing the others where applicable.

2.16 The Committee have concluded that, notwithstanding the residual problems which exist, matters which are clearly of concern to all investors, whether security holders or not, should be found in the Securities Act. The relevant corporations acts will continue to govern the relationship between the shareholder-investor and the issuer. This is not to suggest that the shareholders should receive any less from their company than they are now receiving.

2.17 The yearly and half-yearly financial statements presently required clearly benefit all investors. The information circular now required to be sent also contains this class of information to which would be added in an integrated system further facts. Insider liability strikes at the heart of the question: equality of information in the market place. While on the one hand it does make the insider liable to the company of which he is an insider and in that sense may be argued to be company law, on the other hand in this aspect it is also punitive. The extension of the liability in favour of any investor, buyer or seller, who

deals with the insider to his detriment without the specific confidential information known to the insider, underlines the right to equality of information for all in the market place. Take-over bid legislation clearly is a part of the scheme of securities regulation. We question whether the form of proxies or the manner in which they are to be voted should be continued in the Act although the special provisions regarding the voting by registrants of securities still registered in their names may be viewed as appropriate. These were matters of some importance in attempting to provide for an integrated plan.

CONCLUSIONS AND RECOMMENDATIONS

1. Continuing Disclosure

2.18 We have concluded that the disclosure system initiated in The Securities Act, 1966 provides the basis for a completely integrated continuing disclosure system. In subsequent paragraphs we shall outline the way in which we believe this can be achieved.

2.19 No effort has been made to analyse critically the kinds of disclosure presently required in a prospectus against the information available subsequent to the completion of primary distribution through the reports now required. We have accepted the facts available through a prospectus as the facts which are necessary to an informed investment decision. In speaking of a prospectus standard of disclosure we refer to a standard of disclosure and not to the kind of document through which the disclosure must be made.

2.20 During the course of a primary distribution to the public under the present legislation[50] through the prospectus

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50 See Chapter III.

and amendments to it a minimum standard of disclosure is provided. It is recognized that even with the narrative form of prospectus there are many investors who lack the expertise to utilize the facts made available to full advantage. They rely on the representations made to them by the salesman or their own advisors. The emphasis is on the issue then being sold in many cases and not on the issuer.

2.21 An investor disclosure system would commence with a cornerstone prospectus. The facts then available concerning the issuer would constitute "full, true and plain disclosure" of all material facts relating to the affairs of the issuer. This initial material would be subject to review by the Commission staff in the same fashion a prospectus is reviewed today. After the initial prospectus disclosure the prospectus as we know it should disappear for further public issues and be replaced with some simpler and more basic document which for the purpose of this report we call the "offering circular".

2.22 Once the issuer applies for the privilege of participating in the system it will be obligated to maintain the prospectus standard of disclosure through the filing of quarterly statements. Since the material should be up-to-date, any material change taking place between quarterly reports becomes the subject of a timely amendment in the same fashion that an amendment is now required to a prospectus by section 55 of the Act. The amendment should be filed as soon as practicable but in any event within ten days from the date the change occurs. A yearly statement, incorporating the changes reported coupled with the audited financials, would provide the up-to-date basic summary which could then be reviewed by the investor.

2.23 Excepting for the cornerstone disclosure, these

reports would simply be filed. They would come under immediate scrutiny by the Commission only when an offering circular was required. The offering circular, like the present prospectus, could only be used after it had been submitted to and accepted for filing by the Commission.

2.24 The obvious advantages of such a system became apparent as our study developed. Each problem eventually led to the question of fairness in the market place. If there is an equality of information, as we discuss in Chapters IV to VIII, the necessity for many of the present restrictions on resale will disappear. In the other cases the offering circular required will not only be simpler in form but easier to produce since the detailed basic facts will already be on public file.

2.25 Assuming adequate surveillance and enforcement the result should be a high level of public confidence in Ontario's securities markets. Each investor will himself, or through his advisers, have the opportunity of assessing all the material facts concerning the issuer's affairs. This should add to the breadth and liquidity of the market, particularly when coupled with the assurance which it may be expected will flow from the trading information concerning unlisted securities which will be available through the I.D.A. system[51].

2.26 Companies which are filing reports pursuant to the requirements of the continuous disclosure system are hereinafter referred to as "reporting companies".

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51 The relative importance of continuing disclosure to the investor may be measured by the fact that new issues filed with the O.S.C. in 1968 were less than 10% of the value of trading on the T.S.E. in 1968. The Wheat Report at p.58, shows during the period 1920-1967 the aggregate volume of new equity securities offered for cash was approximately 3.15% of aggregate U.S. exchange trading.

2.27 In order that investors taking securities pursuant to an exemption will know their rights of resale and in order that investors generally will know which issuers are making regular disclosure we recommend that the Commission maintain a current list of reporting companies available to the investing public.

2. Offering Circular

2.28 If a prospectus standard of disclosure is continuously available it should be possible to devise an offering circular containing the salient facts about the company and the purpose of the proposed issue. The responsibility of the underwriter and the issuer would remain the same. The protection which we are told flows from the bargaining process between the underwriter and the issuer would still exist. The circular will be reviewed by the Commission staff. It will also be examined in the light of the facts on file to ensure that adequate disclosure is available. The standards and discretion contained in section 61 will not in any way be reduced.

3. Timely Amendments

2.29 Unlike the present "timely disclosure" policies which contemplate disclosure on occasion before the fact, the timely amendment will be required essentially at or immediately following the event. The fact of negotiations or contemplated acquisitions may be the subject of a press release, a copy of which will continue to be filed. The completion of the transaction will be the subject of a timely amendment.

2.30 We suggest that if language similar to that in section 55 is adopted, for greater certainty, it should suggest some specific circumstances which should lead to an amendment. The Commission's timely disclosure policy gives some direction.

4. Quarterly Reporting

2.31 The Kimber Committee considered the benefits of quarterly reporting[52]. It concluded that cost and inconvenience militated against requiring such reports at that time. In the five years which followed dramatic changes have taken place. The T.S.E. will shortly have virtually all of its listed issuers reporting on a quarterly basis. It would seem incongruous that junior or more speculative issuers ought not to be subject to this requirement on the ground of cost. This, it seems to us, is one of the obligations an issuer assumes when it seeks public financing. We are informed that any reasonably managed company produces these statements regularly, frequently monthly, as an essential management tool. Consequently a company which is not organized to produce such information may be suspect.

2.32 Instead of semi-annual audited financial statements we recommend that quarterly unaudited statements be filed[53]. These will be supplemented for the investor by the timely amendments and the timely disclosure statements filed. Considering the whole, including the cornerstone prospectus or the last annual filing, there should be available a prospectus standard of disclosure.

5. Exemptions

2.33 The Committee recommends that the right to apply to the Commission for relief from the statutory requirements be retained[54]. There have been a number of such applications

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52 See Kimber Report at para. 4.26, 4.27 and 4.28.

53 Statements of source and application of funds, sales or gross operating revenue, extraordinary items of income or expense, and net profit and loss are not required semi-annually by section 129 of the Act.

54 See sections 121(3) and 131(1) of the Act.

made by responsible issuers who felt they might be unable to comply, because of some situation over which they had little or no control[55]. The fact of the application and the result become public knowledge through the Weekly Summary and the public file. On the other hand we reject the general theory offered that seasonal or other conditions peculiar either to the company, the industry, or force of events would render the statements meaningless. Peculiar conditions can be dealt with by way of a note so the reader will not be misled. Normal cyclical variations can be indicated and will be apparent over a period of time. Any argument based on small size or lack of money merely serves to emphasize the need for disclosure in these cases.

6. Shareholder Disclosure

2.34 In recommending that the investor disclosure provisions incorporated in the Corporations Act be repatriated to the Securities Act and in essence declared to be such, it is our hope that the result will not be a reduction in the kinds and quality of information a company will be required to furnish routinely to its shareholders. While we recommend the removal of proxy solicitation from the Act, together with the information circular, we hope that where the public disclosure required by the Act provides for more information than is required to be furnished to shareholders under the basic provisions of the relevant corporations acts, those acts will require the annual continuous disclosure statement to be furnished to the shareholders. Similarly the financial statements required under the Act should

55 For instance in one case a strike and in another a breakdown of a computer made it apparent that with the best of will the required financials could not be produced in time.

correspond, so far as is possible, with the audited statements the company is required to prepare and circulate amongst shareholders under its act of incorporation. The Kimber standards have now been adopted as a matter of shareholder disclosure in most provinces and in the proposed amendments to the Canada Corporations Act, Bill C-4[56]. While every effort should be made to avoid requiring the production of two sets of quite different documents, through discussions between those responsible for the administration of corporation law and the securities regulators it should be possible to frame both acts, as at present, to accommodate the requirements of shareholder and investor protection.

7. Implementation: When Should Continuing Disclosure Apply?

2.35 At present the continuous disclosure requirements of the Act do not apply to all issuers whose securities have been distributed and are publicly traded in Ontario. The Kimber Committee concluded that the jurisdictional as well as constitutional problems militated against any attempt to impose the requirements on any issuer who had ever distributed its securities in Ontario. These considerations still apply. We therefore recommend that generally speaking the expanded disclosure requirements should apply to all issuers required to report under the provisions of Parts X and XII of the Act or the equivalent provisions of the Corporations Act. We further recommend that all companies whose securities are listed and issuers qualifying any

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56 An Act to amend the Canada Corporations Act and other statutory provisions related to the subject matter of certain of those amendments, Bill C-198, given first reading May 22, 1969 in the First Session, Twenty-eighth Parliament; re-introduced with some changes as Bill C-4 in the Second Session, Twenty-eighth Parliament with first reading October 27, 1969.

securities for distribution in Ontario through a prospectus in future should be subject to the system.

2.36 The events subsequent to the publication of the Kimber Report have led us to question the distinction between "equity" and other securities. We feel that all investors should be entitled to the same standard of disclosure and would therefore recommend the distinction be abandoned.

2.37 The details of disclosure and the implementing regulations should be carefully explored with the widest opportunity for discussion. The wisdom of this was demonstrated in the implementation of the existing legislation. It is therefore apparent the implementation of this recommendation must be viewed as a long term project. It is particularly in this area that the widest discussion must take place amongst provincial administrators.

2.38 When the trading information system presently being developed by the I.D.A. becomes fully operational and is capable of providing trading information concerning all unlisted trading in Ontario, issuers who are not required to comply with the disclosure system may be encouraged to do so through either distinguishing on the daily list between those issuers making continuing disclosure or only permitting trading information to be published concerning those issuers making adequate continuing disclosure. Issuers meeting the listing requirements of the Toronto Stock Exchange will be encouraged to seek listing on the Exchange. The argument concerning the burdens of disclosure upon listed companies will disappear. The fact of listing will continue to be a mark of distinction providing access to a better market place.

8. Sanctions

(a) Civil Liability

2.39 Sections 63, 64 and 141 of the Act provide civil remedies, rescission of contract and damages, in those circumstances requiring the filing and delivery of a prospectus. We recommend that these should continue in those circumstances where an offering circular is required. They have been developed to meet the inadequacies of the common law and to give the small investor an effective remedy. They establish on the one hand the need for responsibility for those whose names appear on this kind of filing, either approving or as signatories. On the other hand they act as a deterrent against misrepresentation by providing both rescission and damages.

2.40 We have considered carefully the question as to whether these rights and liabilities should extend to all of the documents we contemplate should be filed in the continuing disclosure system. The statutory provisions override or specify the common law in the five elements of falsity, privity, scienter, reliance and damages. While we believe that the persons responsible for the filing of timely amendments or the regular statements should certify the material or otherwise be identified through the filing of a copy of the directors' resolution approving and authorizing the statement to be filed, it is not contemplated that these materials will be delivered to investors as a matter of securities law. Accordingly we believe that no further extension of liability should take place. We do recommend however that liability be extended to take-over bid circulars which are currently delivered to individual shareholders[57].

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57 See Chapter VII.

(b) Suspension of Trading

2.41 Where the information in the market place is inadequate the Commission has the power under section 141b to suspend trading until such time as the facts, or the absence of adequate facts, is made public. The Commission may also stop primary distribution under section 62.

(c) Denial of Exemptions

2.42 Subsections 5 and 6 of section 19 of the Act enable the Commission to deny any or all of the exemptions from registration, and thus indirectly from the prospectus exemptions, to particular persons or companies.

(d) Restraining Orders

2.43 Section 141a enables the Commission to apply to the High Court for an order restraining continuing violations of the Act. We are hopeful that increasing use will be made of this provision. Firstly, in those areas where the law is new and its precise boundaries may be a matter of opinion, the question of law involved comes before a judge whose decision, and that of the Court of Appeal, will develop a body of definitive case law. Secondly, in such an application because the proceedings are not launched in a criminal court and there are no penal sanctions flowing from them there is less likelihood of injury to the reputation of the parties and consequently the matter is likely to be responded to with more objectivity. Thirdly, a repetition of the conduct complained of in the face of a restraining order is perhaps more serious for the party since he is in contempt of the Court's order.

(e) Securities Act Prosecutions

2.44 Failure to comply with the Act may result in

prosecution in the provincial criminal courts for the statutory offences created by section 136 and elsewhere in the Act. Conviction can result in a fine or jail sentence or both.

(f) Criminal Offences

2.45 Where the documents prove to be instruments of deceit and it can be proved beyond a reasonable doubt that they were intended to produce this result by some ascertainable person the consequence can be a criminal prosecution for one of the kinds of fraud or theft stipulated in the Criminal Code.

9. Effective Dissemination of Information

2.46 The system recommended is ineffective if the result is merely to fill filing cabinets in the Commission's offices. As to the material presently being collected we believe that it has resulted in greater light in the market place. The material is being reviewed by the financial press, the financial analysts, the investment community, and individual investors. Comment is made concerning the material filed. The market place does respond to the disclosure It does far more than satisfy idle curiosity as has been suggested. Our concern lies not with the principle but rather with the speed and effectiveness of dissemination.

2.47 In the time alloted to us we have been unable to do more than to suggest fruitful lines of exploration. At the date of writing we are led to believe that a commercial service will be available in the near future which will supply copies of disclosure material on the O.S.C. public files. Every effort should be made to encourage the media to examine, report and comment upon the information filed.

10. Timely Disclosure

2.48 While there is some evidence that some issuers are prone to premature disclosure or disposed to make announcements concerning events which appear somewhat immaterial, nonetheless we feel that timely disclosure should continue to be encouraged. We have considered the question as to whether it ought to be made a matter of regulation and have concluded that for the time being at least it should remain a matter of policy statement (as opposed to the timely amendment provision which should be legislated).

CHAPTER III

WHO ARE THE "PUBLIC"?

"Primary Distribution to the Public"

3.01 The scheme of the legislation is to prohibit certain courses of conduct and then to provide for exemptions from the general prohibition. Such a prohibition is found in section 35(1) of the Act which prohibits trading[58] in a security "where such trade would be in the course of primary distribution to the public of such security until there have been filed with the Commission both a preliminary prospectus and a prospectus in respect of the offering of such security and receipts therefor obtained from the Director." "Primary distribution to the public" is defined by clause 16 of subsection 1 of section 1 of the Act as follows:

> "primary distribution to the public", used in relation to trading in securities, means,
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> i. trades that are made for the purpose of distributing to the public securities issued by a company and not previously distributed, or
>
> ii. trades in previously issued securities for the purpose of distributing such securities to the public where the securities form all or a part of or are derived from the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of a company to materially affect the control of such company,
>
> whether such trades are made directly to the public or indirectly to the public through an

58 "trade" or "trading" is defined in section 1(1)31 of the Act.

underwriter or otherwise, and includes any transaction or series of transactions involving a purchase and sale or a repurchase and resale in the course of or incidental to such distribution..."

3.02 Section 58 provides the exemptions from the general prohibition in section 35. It does so by stating that section 35 does not apply to trades involving certain classes of persons, companies or securities or dollar value amount of securities incorporating by reference some, but by no means all, of the exemptions from registration found in section 19. We shall be considering these exemptions in depth in Chapters IV to VIII.

3.03 In paragraphs 1.24 to 1.26 we considered the "need to know" philosophy which the Commission has assumed to be the basis of the regulatory scheme. For instance the Act declares that certain types of investors who are willing to invest $97,000 or more are sufficiently astute so as not to require the information and protection afforded by the prospectus requirements of the Act[59]. Similarly the Act declares that securities guaranteed by governments or guaranteed by companies subject to other regulatory authority need not be the subject of prospectus disclosure and review[60].

3.04 The legislators, recognizing that the definition of "primary distribution" was not free of doubt, delegated a form of discretion to the Commission in section 59. While it is impossible to legislate so as to encompass all the permutations and combinations of securities transactions which the combined ingenuity of entrepreneurs, lawyers and accountants may conceive, a party to a contemplated transaction may apply to the Commission for a ruling that the

59 Sections 19(3) and 58(1).

60 Sections 19(2)1 and 58.

transaction would not constitute "primary distribution to the public". The Commission, applying the "need to know" test, frequently declares that the proposed recipient is not the "public". Recently the section was amended by adding a subsection permitting control persons or persons holding securities which have not been previously distributed to the public to apply for an exempting order[61].

3.05 The spate of applications made to the Commission under section 59 since the new Act came into force has largely been the result of uncertainty flowing from the application of the exemptions and the proliferation of acquisition minded companies[62]. The shares which they proposed issuing in consideration for business acquisitions might otherwise have been viewed as issued in the course of primary distribution to the public. This problem is considered in some detail in Chapter VI.

3.06 Our immediate problem was to resolve who the legislation was designed to protect and under what circumstances. The first step was to attempt to clarify the meaning of "primary distribution to the public". If our questions as to the meaning of the persons requiring protection, "public", could be satisfactorily resolved then what are presently considered as problem areas could be assimilated and integrated into the continuing disclosure system recommended in Chapter II. These areas are considered in subsequent chapters.

3.07 In attempting to resolve the problem the Committee has sought to avoid the creation of what is styled

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61 Stats. Ont. 1968, c.123, section 21(1) - now section 59(1a).

62 Between May 1, 1967 and December 31, 1969 the Commission issued 405 orders under section 59. See Appendix VI for a further analysis of these applications.

"letter stock"[63]. Similarly we have tried to reduce to a minimum the situations in which the holder of securities is uncertain as to the circumstances under which he may dispose of his securities. We do not believe that it is in the interest of Canadian investors to encourage artificial or uncertain restrictions leading to the creation of classes of securities which can only be traded amongst sophisticated investors. This has been the result of the private offering exemption in the U.S.A.[64] We have also sought to avoid, excepting within clearly defined limits, the creation of other classes of escrow similar to those which have resulted from section 59(1) rulings based on proposed acquisitions. We wish to encourage the liquidity of the Canadian equity market, not place further restrictions on it.

3.08 We concur in the conclusions of the Kimber Report which states:

> "While the underlying purpose of legislation governing the practices and operation of the securities market must be the protection of the investing public, it is equally true that the character of securities legislation will affect the development of financial institutions and their efficiency in performing certain economic functions. The principal economic functions of a capital market are to assure the optimum allocation of financial resources in the economy, to permit maximum mobility and transferability of those resources, and to provide facilities for a continuing valuation of financial assets." 65

Purpose of a Prospectus or Offering Circular

3.09 We are informed that the process which ultimately

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63 "Letter stock", an American concept, refers to securities issued to an investor who gives an undertaking, usually a letter, to hold such securities for investment. The law is uncertain as to the holding period; section 19(3) of our Act provides the genesis for this class of security in Ontario.

64 Section 4(2) of the '33 Act.

65 para. 1.06.

results in the delivery of a document into the hands of a prospective purchaser has benefits which extend far beyond the obvious purpose of investor information. These are as follows:

(1) During the course of the preparation and investigation necessary to marshall the facts required to be included in the prospectus the issuer must examine in depth its corporate structure, management, purpose and objectives in a comprehensive and pragmatic fashion. The results are frequently of great value to the issuer.

(2) Where the underwriter is independent of the issuer and particularly if it deals with the public the underwriter scrutinizes the affairs of the issuer for two different reasons. Firstly, it wishes to be associated with a successful distribution so that it will not only profit but through a successful financing attract new business. Secondly it hopes that the venture will flourish and that an independent after market will quickly develop. This will insure the satisfaction of its clients and will encourage their purchase of other issues it sponsors.

(3) The regulatory review by the Commission staff is uninfluenced by either profit motive or market pressures. The prospectus is analysed against the standards laid down by the legislature and the policies developed for the guidance of the staff by the Commission.

The Meaning of "Public"

3.10 The legislature has set out to protect the "public" by providing it, at least in the case of "primary distribution", with adequate information upon which to base an investment decision. Judging from the kinds of people

and securities singled out by the combined exemptions in section 19 and section 58 there are circumstances when it did not feel that this protection was necessary. The question we explored is whether these people should not be considered the "public" or whether they are a special segment of the "public" who, having no "need to know", require no special prospectus protection. In this chapter we elaborate on our conclusions. We deal in subsequent chapters with the problems raised by the possibility that exempt persons may be used as conduits for distributing securities to the public.

3.11 The word "public" must be viewed in the light of the regulatory scheme in which it is found. In the context of a distribution to the public three alternative meanings for "public" have been suggested: first that the distribution must be to <u>every</u> member of the community, next to <u>any</u> member of the community, and lastly, the distribution may be to all but <u>certain</u> members of the community. It may be concluded that our present legislation represents a combination of the second and third alternatives. Section 35, as we noted previously, appears to direct its attention to each and every one of us. The exemptions then go on to provide a specific list of exceptions to the general requirement.

3.12 Most of the reported Canadian cases have been concerned with trading in the securities of private companies to the public. In Ontario sections 19(2)9 and 58(2) include the securities of a private company in the exempt class of securities "if the securities are not offered for sale to the public". The exemption in section 58(2) by incorporating section 19(2)9 purports to exempt the trades from a prohibition which is not applicable. This logical paradox

results from the legislative technique adopted of incorporating all of the registration exemptions in section 19(2) by reference. Patently someone must be permitted to invest in private companies. The decisions do little to resolve our difficulties.

3.13 The leading English case on the meaning of "public" in the context of securities legislation, Nash v. Lynde[66], adds to the confusion. The cases to that date are considered in R. v. Empire Dock Limited[67]. The Canadian case which has considered the question in the greatest depth would appear to be R. v. Piepgrass[68]. The Alberta Court of Appeal would apparently exclude, in the case of private companies, "ordinary sales of a private domestic concern to a person or persons having common bonds of interest or association..."[69]

3.14 In the introductory chapter[70] we concluded that we should examine the regulatory scheme in the light of the "need to know" test enunciated in S.E.C. v. Ralston Purina Co.[71] We have concluded that the Legislature intended that

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66 [1929] A.C. 158 (H.L.). See Lord Hailsham, L.C. at p.164 who says in effect that it is an offering to the public if a prospectus is "shown to any person as a member of the public and as an invitation to that person to take some of the shares referred to in the prospectus ..." Viscount Sumner at p. 169 states that it is an offering to the public if it is "open to anyone who brings his money" but that "a private communication is not thus open...".

67 (1940), 55 B.C.R. 34: a decision of a British Columbia County Court involving a wide spread mailing to a special segment of the community.

68 (1959), 23 D.L.R. (2d.) 220 (Alta. C.A.). See also a decision concerning an Ontario private company, R. v. Golden Shamrock Mines Ltd. et al.,[1965] 1 O.R. 692 (C.A.).

69 Id. at p. 228.

70 Supra at para. 1.26.

71 Op. cit. footnote 24.

the protection of the Act should in fact be afforded to virtually everyone excepting those that it specifically exempted from its protective umbrella. It prohibits any primary distribution to the public in section 35 then through an extensive series of exemptions found in section 58, which in turn cross-refers us back to specific exemptions in section 19. Section 58 in reality states that whether, in the case of the exemptions in subsections 1 and 3 in section 19, this purchaser is a member of the public or not, in the circumstances set out in the exemption no prospectus is needed. The exemptions in section 58(2) also appear to remove the prospectus requirement.

3.15 To clear away the confusion which now surrounds the concept of "public" in the present Act we recommend that, excepting for those places in which it is found in section 19(2)[72] the word be eliminated. We, in the chapters following, will examine the exemptions in the light of the need of the particular investors for a prospectus or offering circular. While the continuing disclosure system we believe will provide an adequate standard of investor information these particular recommendations are not predicated on the existence of such a system. Today, it is accepted that, subject to the purchaser or recipient not being a "control person", if the trade is clearly within the exemptions in section 58 (subject to investment intent in the case of a private placee) there are no restrictions on resale. The result of eliminating the use of the word "public" would be that unless the trade falls clearly within one of the exemptions a prospectus or offering circular is mandatory. This will eliminate the necessity for the kinds

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72 Clauses 4, 5, 9 and 12.

of introspective and philosophical examinations of relationships between proposed sellers and buyers that engaged the Committee in attempting to produce a general definition for the word.

3.16 The Commission presently, through applications made to it under section 59(1), resolves the doubt that the applicant may have by declaring the recipient is not the "public" and therefore the transaction would not constitute primary distribution to the public[73]. The results of the Commission's decisions have on occasion been incongruous. We do recommend that section 59(1) and (1a) be repealed and that discretion be granted to the Commission, where in its opinion the prospective purchaser does not need prospectus disclosure, or that the proposed trades would not be against the public interest, to grant an exemption from the prospectus requirements. The power to impose terms and conditions upon the sale and the subsequent resale should also be clearly given. This recommendation is not dependent on a continuing disclosure system.

"Previously Distributed"

3.17 We noted with interest the theories which were advanced on the basis of the failure of the draftsmen to include the words "to the public" after the words "not previously distributed" in clause 16 i of section 1(1)[74]. To clarify the meaning of the present definition we are of the view that the words must be inferred. This has been the constant basis for many of the Commission's recent orders

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73 This problem is specifically discussed in para. 6.01 to 6.08 of Chapter VI.

74 See "Prospectus and Registration Requirements" by R.C. Meech, Q.C. at p. 223 in Developments in Company Law, op. cit. footnote 14.

under section 59(1) where it has found that the vendor of assets, being well protected in the transaction, had no "need to know" or need for a prospectus and therefore could safely be viewed as not being the "public". The shares, although issued for the purpose of acquisition, had thus not been "previously distributed" to the public and could not therefore be freely resold by the vendor of the assets. This ambiguity will disappear if our long term recommendation is adopted that the word "public" be completely removed from the definition.

3.18 It has been the consistent view of the Commission and its staff, extending back for at least two decades, that the combined effect of sections 19 and 58 was to exempt these transactions from the prospectus requirements. In this context we considered that the securities would, once issued to the recipient and in his hands, be "previously distributed" and "to the public" and could therefore be freely resold. With the exception of subsection 3 of section 19, where the recipient has declared his investment intent, and certain exceptions found in section 19(2), unless the seller is part of the control group the Act places no restrictions on the right to resell. This is quite a different position from the private offering exemption considered by the U.S. court in the <u>Ralston Purina</u> case[75].

RECOMMENDATIONS

3.19 (1) The word "primary" in the definition we find to be more confusing than useful. Sales by control persons, as a result, are referred to as "secondary primary distribution". We recommend the word "primary" be deleted

75 Had the exemption been available it would have been premised on the purchasers taking with an investment intent, and resale by those purchasers would not have been possible until the investment intent changed by virtue of a change in circumstances.

from the definition.

3.20 (2) We have considered attempting to define the word "public". Since the proposed regulatory scheme is intended to be all-inclusive, with the residual discretion vested in the Commission, the reference to "public" should be removed. Section 35 would then prohibit a "distribution" to anyone unless a prospectus had been accepted for filing. Section 58 would provide a comprehensive series of exemptions, as at present, from this general prohibition while section 59 would provide the residual discretion. This plan has the merit of both simplicity and certainty.

3.21 When the concept of "public" is removed from the Act the term "distribution to the public" becomes "distribution" and it should be defined as follows:

> "distribution", used in relation to trading in securities, means,
>
> i. trades that are made for the purpose of distributing securities of a company not previously issued, or
>
> ii. trades in previously issued securities where the securities form all or a part of..... 76

The effect of this redefinition would be:

(a) Every issue of a security by any company and every trade in any security by a person defined in branch ii of "distribution" would be a "distribution" subject to prospectus disclosure (if the company is not a reporting company) or offering circular disclosure (if the company is a reporting company) by section 35 unless a specified exemption from such disclosure is available in section 58(1), or pursuant to a section 59 order. Additions to

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76 Amendments to branch ii of the definition are suggested in the next chapter; see para. 4.14.

and modifications of the exemptions in section 58(1) are suggested in chapters V to VIII inclusive.

(b) An amendment to section 58 would impose restrictions upon the resale of securities taken pursuant to an exemption in the following terms:

> "Any trade in any security purchased pursuant to an exemption in section 58(1) is a distribution unless..."

The conditions which would have to be met in order for the trade not to be a distribution would then be spelled out. The standard set of conditions would be that (1) the issuer must be a reporting company, (2) twenty-eight days must elapse from the filing of a timely amendment describing the issue under the exemption, and (3) no selling efforts must be made to trade the securities.

(c) A separate exemption for sales by control persons based on these conditions is described in the next chapter.

(d) Issued securities not subject to a section 58(2) restriction could be freely traded.

3.22 (3) In the short term if the concept of the public is retained, in order to avoid the differences in interpretation which have arisen due to the absence of the words "to the public" in clause i of section 1(1)16 we recommend that they be added so that the clause will read:

> "i. trades that are made for the purpose of distributing to the public securities issued by a company and not previously distributed <u>to the public</u>... "

This definition would operate in a scheme identical to that

outlined in paragraph 3.21, however the key concept would be "distribution to the public" rather than "distribution".

3.23 (4) Section 59(1) should be amended to permit the Commission clearly to exempt a proposed transaction from the requirements of section 35, subject to such terms and conditions as it may impose and always providing that it is satisfied the proposed transaction would not be contrary to the public interest. This is merely an adjunct to the power it already has in section 19(1)3 to grant, upon application, the status of an "exempt purchaser". Section 59, in effect, would permit the granting of the status for a single transaction and not on a continuing basis. Resale of securities taken pursuant to a section 59 order will be governed by the provisions of the order which may be based upon the standard conditions set out in the section 58 amendment proposed above. This approach is extremely important to the comprehensive plan founded on the "every person" prohibition in section 35 and a comprehensive "need to know" exemption scheme sponsored by the continuing disclosure system. Section 59(1a) would become redundant and could be repealed.

3.24 (5) The continuing disclosure system will require the following:

(a) Where securities are being distributed for the first time, this will constitute the initial distribution to the public requiring a prospectus under section 35;

(b) Where the issuer or an underwriter wishes to effect an additional distribution and the issuer is a reporting company an offering circular must be submitted to and accepted for filing by the Director; and

(c) In the case of an exempt transaction we believe that a timely amendment filed reflecting the material facts of the exempt transaction, will provide adequate investor information.

3.25 (6) It was suggested that we recommend that the Commission authorize its legal staff to issue the type of "no action" letters which are written by the S.E.C. staff. We think this practice would prove to be unsatisfactory. Rulings may be obtained under section 59 relatively quickly. We are informed that some period of time must elapse before a reply is forthcoming from the S.E.C. The suggested amendments should reduce the uncertainty and therefore the necessity for both applications and opinions. This is not to suggest that there should be any lessening of the present practice of informal consultation as to problem areas with the Commission staff. In unique cases the staff may feel it appropriate to refer the problem to the Commission itself through a specific application or on a question of principle.

3.26 (7) Through section 59 applications the Commission becomes aware of new developments in corporate financing. In subsequent chapters, based upon the most frequent kinds of application, we recommend that private acquisitions be catered for through specific exemptions. Through experience gained from section 59 applications the Commission may recommend further statutory exemptions be added to section 58.

3.27 (8) As a matter of drafting technique it is recommended that for greater certainty and clarity the exemptions based on the "need to know" concept incorporated in section 58 by cross-reference to subsections 1 and 3 of section 19 should be set out in detail in section 58.

CHAPTER IV

CONTROL PERSONS

The Regulation of Control Persons

4.01 Control persons become enmeshed in the regulatory scheme through section 1(1)16 ii which defines "primary distribution to the public" to include,

> " ii. trades in previously issued securities for the purpose of distributing such securities to the public where the securities form all or a part of or are derived from the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of a company to materially affect the control of such company..."

Unless, as discussed in the previous chapter, an exemption is available or is obtained through section 59(1) and (1a) the control persons must comply with the provisions of section 35.

Who are "Control Persons"?

4.02 It will be noted that the definition does not require that the control person (which includes a "company" or a combination of "persons and companies" for the purpose of this chapter) actually exercise control but merely that he should be in a position to materially affect control. We have concluded, in the absence of evidence to the contrary, the position should crystallize when the holdings reach 20% of the outstanding voting shares. This is the standard for control established by section 80(g) in the definition of take-over bid. In the absence of actual control each case must currently be considered on its facts.

4.03 The control position may be arrived at in several ways, the following being among the most common:

(a) The control person may be the original promoter and have achieved his position as a result of the sale of assets or the provision of services in return for securities as well as through private subscription.

(b) The position may be achieved, intentionally or otherwise, through purchases in the market, by private agreement or through private placement, or directly through an exempt or non-exempt cash or share take-over bid.

(c) It may occur during the course of what is sometimes referred to as a reverse take-over that the share consideration offered for the target company is so large that the control persons in the offeree company actually obtain control of the offeror.

The Need for Special Regulation

4.04 Historically the following appear to be the reasons for requiring prospectus disclosure by the control person:

(a) Because of his special relationship the control person might well have access to information not available to the remaining shareholders and the public enabling him to buy and sell to his personal advantage.

(b) He has a special interest in ensuring that the market price of his securities

does not fall and is exposed to a temptation to manage the company's affairs or the news concerning the company's affairs so as to cast them in the best light during those periods when he wishes to sell, or perhaps equally as important, when he wishes to use his securities as collateral for a loan or margin for his brokerage account. (These suspicions were voiced to us on several occasions in connection with the premature announcement of proposed take-over bids which were not proceeded with for reasons which in retrospect should have been apparent at the time the announcement was made. It is conceded the "timely disclosure" policies raise real problems for the conscientious entrepreneur.)

(c) The precipitate sale of a control block may have a disastrous effect on an orderly market to the detriment of all shareholders.

(d) The control person may actively participate in or influence the quality of management - he is frequently the vital force in the company - and his decision to withdraw from the company may be a piece of essential investor information.

4.05 The definition does not now distinguish, as did its predecessors[77], between the sale of voting and non-voting securities from the holdings of a control person. The reasons given above would apply in whole or in part to non-voting securities[78].

Relief from the Prospectus Requirements

4.06 While section 59(1a) did provide some limited relaxation in these restrictions[79], the control person remains generally speaking subject to prospectus requirements should he wish to sell. The amendment to section 58 in the 1966 Act requires a control person in a listed company to file a statement of material facts before he can sell his securities through the facilities of the Exchange. This change has further contributed to the "thinness" of the Canadian securities market by reducing its liquidity and its ability to respond speedily to changing conditions.

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77 See the definition of "primary distribution", section 1(1)(ii), The Securities Act, R.S.O. 1960, c.363.

78 In its Famous Players Canadian Corporation Limited decision, May 1969, O.S.C.B. 83, the Commission clarified its position in this regard.

79 Section 59(1a) reads as follows:

"(1a) Where, upon an application under subsection 1, the Commission is satisfied that,

(a) the number of securities is not substantial in amount in relation to the holdings of the offeror or proposed offeror; or

(b) the proposed purchaser is acquiring the security or securities for investment purposes with reasonable knowledge of the affairs of the issuer,

and, in the opinion of the Commission, to do so would not be prejudicial to the public interest, the Commission may rule that, subject to such terms or conditions as the Commission imposes, the trade or intended trade shall be deemed not to be a primary distribution to the public and the ruling of the Commission is final and there is no appeal therefrom."

(It has also reduced the temptation to manage news so that the control person can sell on the rise and retrieve his overall control position when the price drops.)

4.07 Section 58(2)(c) was designed to provide some additional relief for the control person in a listed company. It exempts "isolated trades not made in the course of continued and successive transactions of a like nature" through the facilities of the Exchange.

4.08 The control person, like the issuer, is also free to trade through any of the applicable exemptions in section 58, including to exempt institutions and by way of private placements.

4.09 The revision of section 59(1) recommended in paragraphs 3.19 and 3.20 would enable the control person, pending the establishment of a fully integrated continuing disclosure system, to apply for a broader exemption than is presently available under section 59(1a)[80].

Control Persons in the Continuing Disclosure System

4.10 With the advent of the insider liability provisions of section 113 the control person, who normally would also be an "insider" or "associate" by definition[81], trades on the basis of specific confidential information at his peril.

4.11 As to the other reasons for prospectus disclosure outlined in paragraph 4.04, we have concluded that in a continuing disclosure system, provided that no special or

80 The Commission, because of the broader disclosure available under the present legislation, has issued policy guidelines indicating its approach to section 59(1a) applications (see for example 1968 Nov., O.S.C.B. at p.237). We have not attempted to consider these since the approach has been pragmatic, based on the kinds of applications made. In any event they will vary with the implementation of the findings in this report.

81 See section 108(1)(c) and section 1(1)1 of the Act.

unusual efforts are made to groom the market or to create a demand for the securities, the control person should be free to sell his securities subject to his promptly reporting the change. The simplest way of achieving this is to require the filing of an insider trading report by the control person within three days of the trade. The Commission should promptly announce this fact through financial news services, its Weekly Summary, and any further method considered helpful to investors. At the same time these reports will enable the control person to comply with the insider reporting requirement, i.e. that he report his trading within ten days in the month next following the trades. The insider trading reports, Forms 14 and 15[82], require the reporting of trades in all classes of securities, whether voting or not.

4.12 Apart from the equality of information aspect catered for by insider liability the Commission's investigations and experience demonstrate that the creation of a demand for securities is a sophisticated and sometimes subtle art. The employment of public relations firms whose efforts often appear to be directed to producing a corporate image rather than marketing the products or services of the corporation gives rise to a concern that there may be more emphasis in certain cases on market price than on earnings. The assurance of such support by the company to maintain present market prices and sustain a demand for additional securities may well influence other sophisticated purchasers, exempt purchasers and private placees, when an issue is being placed "privately". Less subtle, but equally difficult to prove, are the "touting" campaigns done by word-of-mouth

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82 O. Reg. 101/67.

where professional rumour mongers and, we have reason to believe, securities salesmen are hired to encourage the purchases of a particular stock.

4.13 Continuing disclosure should provide the investor with timely facts upon which his investment decision may be based. The regulatory authorities, the Exchange and the Commission, must remain diligent to act where the market responds to a whispering campaign. Trading should continue to be suspended until the available facts are made public. At the same time any general exemption provided for resales by a control person should as we noted in paragraph 4.11 be conditioned on his not making any effort, direct or indirect, to create a demand for his shares or in selling them. Simply he would be limited to offering them through his broker for the normal commissions payable on such transactions.

RECOMMENDATIONS

4.14 (1) We recommend that the position of the control person be crystallized by making an addition to branch ii of section 1(1)16 so that it reads:

> "trades in previously issued securities for the purpose of distributing such securities to the public * where the securities form all or a part of or are derived from the holdings of any person, company or any combination of persons or companies holding a sufficient number of any of the securities of a company to materially affect the control of such company, <u>provided that any person, company or any combination of persons or companies holding more than 20% of the outstanding equity shares in a company shall in the absence of evidence to the contrary be deemed to materially affect the control of such company..."</u>

> * It is recommended that for the purpose of distributing such securities "to the public" be removed from this definition in the long term at para. 3.21 *supra*.

4.15 (2) With the implementation of a continuing disclosure system, the control person should be free to sell, providing:

(a) Twenty-eight calendar days have elapsed since his control position was disclosed, e.g. through the filing of a timely amendment or the publication of appropriate insider trading information;

(b) The issuer is a reporting company;

(c) The control person in offering his securities for sale makes no special effort, direct or indirect, to market the securities, and offers no special inducement to the broker to effect sales apart from the commission normally payable on such transactions; and

(d) The control person reports the trades within three days to the Commission through an insider trading report.

An exemption for a control person based upon the above requirements should be included in the amended section 58. In defining "special selling effort" the factors set out in paragraphs 4.12 and 4.13 should be considered[83].

4.16 (3) If the issuer is not a reporting company or sufficient time has not passed to permit the control person the benefits of the exemption, his position may remain little changed. However, if section 59(1) is amended to provide broader discretion in the Commission, he may apply for relief under that section. With a reporting company if the control person feels a special sales effort is required he will be able to file the simpler offering circular and distribute pursuant to this circular.

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83 The language of section 19(1)8 iii will be helpful in defining selling efforts.

CHAPTER V

EXEMPT PURCHASERS AND PRIVATE PLACEMENTS

Their Significance

5.01 The Commission was aware that frequently the funds necessary to finance acquisitions, as well as for other corporate purposes, were raised through an offering of securities under exemptions from the registration and prospectus requirements. The particular exemptions of concern in this chapter are found in a combination of either section 19(1)3 (hereinafter referred to as the "exempt purchaser" exemption) or section 19(3) (hereinafter referred to as the "private placement" exemption) with section 58(1).

5.02 The issuer thus may be able to raise funds relatively speedily and economically. A prospectus is not required. The intervention of a registrant is not required even though he often plays an important role in arranging additional financing. The issuer can place smaller dollar amounts of securities than an underwriter would find economical. The purchasers, being sophisticated, we are informed frequently demand higher standards and more penetrating disclosure than is required by the Act. Unfortunately, this disclosure is made privately and does not become a matter of public record. It is therefore of little assistance to investors generally.

5.03 Complete information is not available as to the quantity, kind and dollar value of securities sold to exempt purchasers. Unlike the reporting requirements for private

placements[84] where the issuer and its agent is obliged to file a report with the Commission, no similar reporting requirement presently exists for trades to exempt purchasers. With respect to listed securities however the Exchange does have information concerning both exempt purchases and private placements made under the Act. During the period July, 1967 to June, 1969 the private placements reported to the Commission through Form 8's amounted to almost $500,000,000 with nearly $300,000,000 of this amount being placed in the January - June, 1969 period[85]. The Toronto Stock Exchange advises us that over $140,000,000 worth of securities were placed pursuant to these exemptions and reported to it either through the listing of additional securities or through the provisions for additional securities which might issue as the result of conversions. Over 90% of this amount represented securities of companies listed as industrial companies while the balance were mining and oil companies.

5.04 These statistics confirmed our information. The facts raised serious question as to whether these exemptions were intended to permit the ultimate distribution of quantities of securities to the general public involving many millions of dollars. The result, in at least one case, was the ultimate distribution through this route of more securities than had been distributed through underwritings. Through take-overs and other forms of acquisitions the size

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84 O. Reg. 101/67, s. 7 and Form 8 made pursuant to s. 19(3) of the Act.

85 Appendix VI contains a statistical summary based on Form 8 reports. The information obtained from the Toronto Stock Exchange will be found in the briefs and research material collected for the use of other researchers all of which will be lodged in the Departmental Library.

and character of many companies have materially changed. While admittedly in the case of listed securities some disclosure is required through the listing of the additional securities, the present law imposes no meaningful restriction on the right to resell the securities into the market place but permits resales without the benefit of a prospectus standard of disclosure and without the rights and obligations which flow if such disclosure is deficient when the distribution is required to take place under a prospectus or a statement of material facts. The policies of the Commission, both "timely disclosure" and its method of dealing with section 59 applications, seek to remedy these deficiencies.

The Issues

5.05 We have thus directed our attention to the following questions:

(1) What classes of investor should an issuer be able to approach under either of these exemptions?

(2) What standards of disclosure ought to be required, when, and to whom, before the issuer may receive the benefit of either exemption?

(3) What reporting requirements should there be, if any, on the persons who receive shares under either exemption?

(4) What restrictions, if any, should there be on the purchasers' right to resell the securities?

Exempt Purchasers

5.06 The exempt purchasers defined in section 19(1)3 fall into two classes. The first group includes government regulated institutions - banks, insurance companies, loan and trust companies, and the government and its instrumentalities. The second consists of those granted the status by the Commission.

5.07 The first group is generally referred to as "institutional investors" as defined by section 19(1)3 as follows:

> "... a bank to which the Bank Act (Canada) applies, or the Industrial Development Bank incorporated under the Industrial Development Bank Act (Canada), or a loan corporation or a trust company registered under The Loan and Trust Corporations Act, or an insurance company licensed under The Insurance Act, or is an officer or employee, in the performance of his duties as such, of Her Majesty in right of Canada, or of any province or territory of Canada, or of any municipal corporation or public board or commission in Canada ..."

This part has been continued from Ontario's first Act[86].

5.08 The second class of investor was added to the exemption in 1963[87]. It underlines the "need to know" concept, as follows:

> "... a person, other than an individual, or a company recognized by the Commission as an exempt purchaser ...."

Form 6 in the regulations describes the kinds of information required by the Commission upon which it bases the exercise of discretion. It is a logical extension of the "need to know" approach.

5.09 At the present time the Commission has recognized approximately 100 parties as exempt purchasers. These are

86 The Securities Frauds Prevention Act, Stats. Ont. 1928, c.34, s. 3(3)(c).

87 Stats. Ont. 1962-63, c.131, s. 10(1).

largely substantial financial institutions which, while not licensed to do business in Ontario, represent substantial pools of capital with sophisticated investment advisers. Others include professionally managed pension funds and mutual funds.

5.10 Section 58(1) exempts the trades to these parties from the prospectus requirements in the following language:

> "Section 35 does not apply to a trade where the purchaser or proposed purchaser is a person or company referred to in item 3 of subsection 1 of section 19 or in subsection 3 of section 19..."

Private Placements

5.11 Section 19(3) states:

> "Subject to the regulations, registration is not required in respect of a trade where the purchaser is a person, other than an individual, or company who purchases for investment only and not with a view to resale or distribution, if the trade is in a security which has an aggregate acquisition cost to such purchaser of not less than $97,000."

The prospectus exemption is set out in paragraph 5.10.

5.12 This exemption, using the test of size of purchase and organization, was added to the Act to overcome a reluctance on the part of large sources of capital within Canada and elsewhere which apparently could not be persuaded to apply for the "exempt purchaser" status. It would seem that for the most part, had these parties made application, they would have been granted exempt status.

The Individual

5.13 As a matter of legislative philosophy neither exemption is available to an individual. There are without question many individuals, having funds in their own right, who are as competent or have as competent advisers available as any other "person". The concept of "individual" appeared

first in what is now section 19(1)3 in 1963 and was aimed at preventing any general solicitation of unsophisticated "individuals". The private placement exemption represented a further departure. It was assumed that the individuals participating in some business organization would have some business experience and would seek out advice[88]. It was certainly not intended to permit pools of individuals to be formed having collectively $97,000 to invest but whose individual investment was less.

Restrictions on Resale

5.14 So far as the issuer is concerned, it must be satisfied that the private placee is purchasing "for investment only and not with a view to resale or distribution" in order to complete and file with the Commission the private placement report. The report, Form 8, is for the private information of the Commission. This form requires, *inter alia*, information from the issuer and its agent as to the security, the name of the purchaser and the size of purchase, and the details of the inquiries made by the issuer to ascertain the investment intent of the purchaser. The questions raised by requiring "investment intent" have yet to be resolved in the United States where "letter stock" and the allied concepts raise more questions than they answer. This reasoning we are advised is reflected in the opinions presently given by the legal profession in Canada.

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88 We were informed that opinions had been offered that several people were entitled to unite as a partnership for the sole purpose collectively of acquiring $97,000 worth of a particular security pursuant to section 19(3). The assembly of several purchasers into a $97,000 unit, whatever its ultimate appearance, would appear to constitute unlawful primary distribution since the exemption is only available when the issuer is offering units of $97,000 or more.

5.15 We are informed that the language of section 58(1) is intended to confine the institutional exemption to the exempt parties set out in section 19(1)3 when they purchase for their own accounts. We learned that some of these institutions feel that they are entitled to purchase through this exemption as an agent for an otherwise undisclosed principal. Since there is no minimum dollar amount or other qualification stipulated by the exemption and there is no explicit restriction on resale, to permit the sale to an individual using a bank for instance as the agent or as ostensible purchaser would render the exemption farcical. In at least one instance we are advised that the issuer sought to sell to exempt purchasers, notwithstanding the fact that the blocks of securities being offered could have been sold to private placees under section 19(3). The securities were offered at what is the normal discount below the existing market price with the added inducement that in a volatile active market there would be little difficulty in reselling. The purchaser, of course, was not inhibited by any declaration as to its investment intent. (We question whether the person offering this advice had considered the definition of "underwriter" contained in section 1(1)32 and the prohibition against acting as an underwriter without registration contained in section 6(1)(d).)

5.16 The Committee had the benefit of a review conducted by the Commission early in 1969 of the use made of the exemption by the "recognized" exempt purchasers. The results suggest that the need this status was originally meant to fill is now adequately catered for by the private placement exemption. Since both exemptions are aimed at meeting a similar need we see no valid reason why the

conditions under which the purchases may be made and the consequent restrictions on resale should not be identical.

The Problem of Resale

5.17 In paragraph 5.04 we noted the problem of investor disclosure raised at the time of the original sale. Here we are concerned with the problems raised through resale by either exempt purchasers or private placees if the exemptions, in fact, place few or no practical restrictions on resale. We have noted the possibility that the exempt purchaser who immediately resells will be held to be an underwriter[89]. In the case of private placements, even where there is a *bona fide* investment intent at the time of purchase, the variety of legitimate circumstances which can alter that intent are almost infinite. The ingenuity of those who may have no *bona fide* investment intent, whatever their declaration, may be conjured with. Penal statutes are interpreted strictly by our courts. We must conclude that unless the evidence is so compelling as to demonstrate that the purchaser was an underwriter (purchasing with a view to a primary distribution to the public)[90] the restrictions are minimal. Restraining order applications[91], over a period of time would permit our courts to define investment intent for us.

5.18 It has been suggested that trades exempted by section 58(1) are not to the "public" and therefore the securities have not been "previously distributed" within the meaning of section 1(1)16. This argument is not persuasive. The form of the exemptions makes it clear that the parties

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89 *Supra* para. 5.15.

90 See s. 1(1)32 of the Act.

91 See s. 141a of the Act.

who are permitted to purchase under the exemptions are members of the public who, for some particular reason, do not need the protection of prospectus disclosure. Generally speaking we view the securities acquired under these exemptions as having been distributed to the public.

5.19 As a result of these exemptions and the subsequent resale of the securities the exemptions may become conduits for distributing quantities of securities to the general public without adequate disclosure. The problem becomes most acute where little information is available about the fact and purpose of the exempt sales. Under existing policy and regulations a timely prospectus standard of disclosure is not normally available. The sophisticated purchasers, in a volatile rising market, may with justification decide that the market price is at an unrealistic level and, in the exercise of good judgment, sell and take a profit. The clouded climate which results in the sale by the sophisticated investor illustrates the necessity for better disclosure for the protection of his less sophisticated brother.

<u>Investment Intent and "Letter Stock"</u>

5.20 In our discussions it was generally suggested that the "exempt purchaser" category should not be repealed. It was also agreed that there was no reason for distinctions as to the right to resell between it and private placements. With respect to "investment intent" it was suggested that some statutory escrow period should be stipulated to avoid the confusion which exists in the United States. The so-called "letter stock" purchased for "investment only" which is traded at a discount below market price between certain

classes of investors in the United States has given rise to many problems. One of these is the problem a mutual fund has in valuing the securities for the purpose of computing net asset value. The experience in the United States leads one to conclude that opinions as to the circumstances required to demonstrate bona fide investment intent vary from lawyer to lawyer. There appears to be the same genuine confusion among Canadian legal practitioners.

5.21 We have concluded that a form of lengthy escrowing, whether for six months, one year or two years (all periods which have been suggested) does not meet the central issue - adequate disclosure. It would not add to the depth and liquidity of our market place. It has been submitted that this might discourage this form of sophisticated financing. There are efficiencies of economy and time which commend the exemptions to issuers. We are seeking a solution which while imposing the fewest restrictions would provide far more adequate disclosure for investors than is presently available: straight-forward and self-operating laws rather than a conglomerate of complex and confusing regulations. The continuing disclosure system recommended in Chapter II offers this solution.

RECOMMENDATIONS

5.22 Dealing with the first question in paragraph 5.05 we have accepted the submissions that the present classes of exemption from the prospectus requirements should be continued with the following amendments:

(1) The purchasers contemplated in section 19(1)3 should be subject to the same conditions that exist in section 19(3), excepting the dollar amount of the purchase. They should

be permitted to purchase "for investment only and not with a view to resale or distribution." This will remove any suggestion that section 19(1)3 is immediately available as a conduit for primary distribution to the public without adequate disclosure.

(2) Section 58(1) should be amended to make it clear that the exemption is available only when the purchaser is purchasing as principal, i.e. for its own account.

(3) We recognize the desirability of permitting trust companies to continue the practice of purchasing by way of private placement for fully managed accounts. We also recognize the desirability of permitting the trust companies to continue purchasing as trustees as well as for their own account. Where they act as custodians and agents and not as trustees they may apply for exempt status for the particular pension fund or other account with which they are associated.

(4) While the Commission's survey of exempt purchasers suggests that the status fills no real need, because of the resistance to its abolition (the suggestion being that it permits sales of less than $97,000) we have not recommended its deletion. We do consider it a status which should be reviewed from time to time and accordingly recommend that the status, as with registrations, should be granted on a yearly basis, renewable on the anniversary date of the original grant. It follows that the status of existing exempt purchasers should be put on this basis as well.

(5) Complaints were received that it is difficult to obtain an up-to-date list of exempt purchasers. In fact the

list was first completely published in 1967 and the additions and deletions are set out in the Weekly Summary. A complete list is maintained by the Deputy Director, Registration. Provision should be made in the regulations for the reproduction of the current list upon payment of a reasonable fee.

5.23 Turning next to the question as to what standards of disclosure ought to be required, when, and to whom, we make these recommendations:

(1) Timely disclosure is fundamental in the long term to our recommendations. We therefore recommend that these exemptions not be available to an issuer unless,

   (a) it is a reporting company;

   (b) it files a timely amendment with the Commission disclosing the details and purpose of the issue, purchases and the numbers, but not the names of the purchasers, not later than ten days after the receipt of the subscription; and

   (c) it files or causes to be filed with the Commission for its private information at or before the time of sale a revised Form 8 signed by the purchaser setting out the details of the purchase, including the names of the managed accounts, where applicable, and the amounts taken for each and stipulating investment intent.

(2) While the onus should still remain on the issuer to supply the necessary documentation ((b) above) we recommend that section 7 of the regulations[92] and Form 8 should be revised so as to require the filing of a form signed by the purchaser giving the details of its purchase

92 O. Reg. 101/67.

and certifying as to its investment intent. In this way the purchaser becomes immediately responsive to the enforcement provisions of the legislation.

(3) We are advised that the filing of a timely amendment provides little problem in a private placement. The sophisticated investors normally require factual disclosure at least as high as that which would be required for a prospectus amendment. The timely amendment, as with a prospectus amendment, must be approved by the board, signed and certified, and filed immediately following closing. It would be accompanied by the independent reports or appraisals which would normally accompany an amendment to a prospectus.

5.24 Our recommendations as to the reports to be required of the issuer and purchasers are set out in (1) and (2) of paragraph 5.23. We further recommend that the purchasers be required to report any sales made within 10 days of the sales, again for the private information of the Commission. This will enable the Commission to appraise the effectiveness of the system in providing liquidity and at the same time assist in pin-pointing inadequacies in disclosure or other inequities in the market place affecting the general public.

5.25 Lastly, as to recommendations concerning restrictions on resale, we have recommended the exempt purchasers be subject to the restriction of "investment intent". Since this intent is subject to the uncertainties discussed in paragraph 5.14 and following we recommend these exemptions be incorporated into the continuing disclosure system as follows:

(1) Section 58, or its equivalent would continue to exempt the sales to exempt purchasers or by way of

private placement but would prohibit resales unless the issuer is a "reporting company" and there is no special sales effort. "Sales effort" is described in a similar recommendation concerning "control persons" in Chapter IV.

(2) Where the issuer is a reporting company until a timely amendment is received, as recommended in paragraph 5.23 (1), and 28 calendar days have elapsed from the date the timely amendment is filed, section 58 would prohibit resale without an offering circular. At the end of the period, subject to the obligation of the purchaser to advise the Commission of the sale in accordance with paragraph 5.24, there would be no further statutory restriction on resale. The Commission would not be concerned with investment intent except in support of the recommendations in paragraph 5.24. If the purchaser proceeds to act as an underwriter he can be dealt with for a violation of section 6.

5.26 We recognize that the holding period, 28 days, will be considered short. The permutations and combinations of alternatives inevitably lead to longer and uncertain periods of restriction. They also lead, in one form or another, to letter stock and the problems it raises. If, as we have concluded, a high continuing standard of disclosure is coupled with sufficient delay to permit adequate exposure of facts, we cannot see that an imposition of an escrow penalty or longer holding period would assist either the issuer or the investor. Prior to May 1st, 1967 there were relatively few restrictions on the resale of securities listed on the Toronto

Stock Exchange. Through their listing the market was aware of the overhanging block of stock and took this into account in establishing a price. We believe the same will be true in a continuing disclosure system. Added time restrictions make the exemption less attractive to the purchaser with the result that a larger discount must be offered to the point where the exemptions would serve no economic purpose. It will be borne in mind that we recommend increased enforcement activity to encourage compliance. Finally, it should be emphasized that the exemption is designed for investors and not underwriters. It may still be difficult for "investors" whose reports show a propensity to hold for very brief periods or others whose intent is to make short-swing market profits to avoid being classed as "underwriters".

BUSINESS COMBINATIONS

The Evolution of the Exemptions

6.01 Until May 1st, 1967 when Part IX of the Act provided a code for take-over bids, business combinations, including acquisitions, were largely excluded from the registration and prospectus requirements of the legislation. Section 3(3)(f) of the 1928 Act[93] provided an exemption where there was "an exchange by or on account of one company with another company of its own securities in connection with a consolidation, amalgamation or merger of either company". In the years that followed the word "re-organization" was added[94]. In 1967 the new take-over bid exemption was grafted to the end of section 19(1)9. The section now exempts the following trades from the registration requirements:

> "A trade in a security of a company that is exchanged by or for the account of such company with another company or the holders of the securities of such other company in connection with a consolidation, amalgamation, merger or re-organization of either company or in connection with a take-over bid as defined in Part IX."

Section 58(1) exempts these trades from the prospectus requirements of section 35.

"Exempt Offers"

6.02 The business climate today is a far cry from that of 1928[95]. In 1928 the board room door was locked and

93 The Securities Frauds Prevention Act, Stats. Ont. 1928, c.34.

94 The Securities Act, 1947, Stats. Ont. 1947, c.98, s. 19(2)(b).

95 For a discussion of the economic factors underlying the urge to merge, see Appendix IV.

guarded. Today, by comparison, the director of a company whose securities are publicly traded is allowed few secrets. Responsible and responsive disclosure has been largely accepted. Until the events which resulted in this study, no consideration was given to amending section 19(1)9 - the key to the regulation or non-regulation of business combinations.

6.03 The absence of any reported policy, and very few reported decisions prior to 1967, suggest that either the Commission took a liberal view of the scope of the exemption or, in the absence of the acquisition fever, there were fewer apparent problems. The truth may be found in both theories. With new legislation and the reluctance of the Commission to offer opinions as it had previously concerning the application of the exemption to a particular fact situation the Commission faced an increasing volume of applications under section 59[96]. A substantial number of these applications flowed from share exchange acquisitions. These involved offers exempted from the take-over bid requirements of Part IX[97].

6.04 The "exempt offers" involved either a private agreement[98] or an offer to purchase shares in a private company or a public company having less than fifteen shareholders of record in Ontario[99]. Since these were by definition not take-over bids the exemption contained in section 19(1)9 and section 58(1) by implication was not available to the issuer.

6.05 The Commission examined the needs of the selling

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96 Op. cit. footnote 62.

97 Section 80 of the Act defines "exempt offers" and "take-over bids".

98 Section 80(b)(i).

99 Section 80(b)(iii).

shareholders (vendors) in the course of the section 59 applications. In the majority of cases the bargaining process leading up to the agreement satisfied the Commission that the vendors did not need prospectus protection. They were content to sell their business in exchange for shares. As to the question of whether the trade constituted primary distribution to the public, the Commission, applying the need to know philosophy, found the vendors were not the "public".

6.06 Where the acquisitions were relatively small and isolated the resulting orders gave the Commission little concern. But certain companies made a series of such applications with the result that the size and character of these companies were drastically altered. The Commission became increasingly concerned about the lack of adequate and timely disclosure concerning both the isolated and collective acquisitions and their relationship to the affairs of an acquisition minded issuer. While some disclosure was available in the case of listed companies as the result of the applications to list the additional shares issued in the course of the acquisitions it was less than adequate. The timely disclosure policy did not require detailed disclosure.

6.07 In April 1969 the Commission's concern was crystallized in a policy statement setting out its views[100]. It pointed out that the result of its declaration that particular transactions did not constitute primary distribution to the public was that no distribution to the public was deemed to have taken place. There having been no distribution to the public then any resale would be a primary distribution "to the public". The policy, subsequently amended in November 1969[101],

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100 April 1969, O.S.C.B. at p. 71.

101 December 1969, O.S.C.B. at p. 185.

did encourage applications for exemption under section 59(1) - (1a). The exemptions were predicated on the issuer making timely and continuing disclosure in accordance with the existing legislation.

6.08 While many lawyers were advising their clients to apply to the Commission under section 59, others, presumably on a "need to know" basis similar to that being applied by the Commission, were offering opinions that the offerees were not the "public" and therefore no prospectus was required. The Commission, under section 59(2), has the power to exempt these transactions from the registration requirements. No explanation was offered as to how the registration problem was met by any of the exemptions in section 19 unless the trades were effected solely through a registrant under section 19(1)7. The isolated trade exemption in section 19(1)2 is of little assistance when previously unissued securities are intended to be the consideration[102]. If the transaction results in one of the business combinations provided for in section 19(1)9 then, of course, the question as to whether the offerees are or are not the "public" is of little consequence since the transaction is exempted from the prospectus requirements by section 58(1). In that case it would be better to offer the opinion they are the "public" since no restriction on resale would then be implied.

6.09 So far as the "exempt offer" share exchange acquisitions are concerned the Commission through its treatment of the section 59 applications had created another class of exemption. We have concluded that this should be included in the statutory exemptions.

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102 An issuer cannot own its authorized and unissued securities.

6.10 "Re-organization" was added to the original exemption in the 1947 revision of the legislation[103]. Following the discussions which led to the present Act, members of the legal profession were properly much more reluctant to offer opinions which would give the exemption the broad scope which had been attributed to it for many years. It had always been difficult to offer such opinions when something less than an actual business fusion or a fusion of the assets was intended.

6.11 The "amalgamation" provided for in section 19(1)9 we believe to be the statutory amalgamation provided for in section 96 of our Corporations Act[104]. A substantial amount of disclosure must be made to the shareholders through the information circular which is sent out prior to the general meeting required to be called to consider the amalgamation agreement[105]. Item 10 of the circular provides that the disclosure be sufficient "... to permit shareholders to form a reasoned judgment concerning any such matter...."[106] This material, as a matter of investor disclosure, must be filed with the Commission[107].

6.12 Statutory amalgamations provided for in several other Canadian jurisdictions require similar investor dis-

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103 *Op. cit.* footnote 94.

104 R.S.O. 1960, c. 71, as am. The Companies Branch advises us that the number of amalgamations under the Corporations Act by year since 1965 is as follows:

1965 - 39
1966 - 49
1967 - 65
1968 - 82
1969 - 119.

One or two each year involve public companies.

105 Sections 75b(1), 75d(iv) and 75c(1)(a) combined.

106 O. Reg. 130/67 - Form 3 (Corporations Act).

107 O. Reg. 101/67 - s. 40 (Securities Act, 1966).

closure. In connection with exemptions generally we have examined the so-called "no sale" rule in the United States. Rule 133 to the '33 Act exempts a statutory merger or consolidation or reclassification of securities or a proposal for the transfer of assets to another person or company in consideration of the issuance of securities where the agreement must first be approved by shareholders by reason of either the provisions in corporation law or in the company charter[108]. The Wheat Report recommends that the rule be replaced by a special registration procedure[109]. Our conclusion is that shareholder protection should remain a matter of corporation law. Resale and investor protection are discussed subsequently in this chapter under "Recommendations"[110].

6.13 "Merger and Consolidation" have not been the subject of judicial interpretation in the context of securities regulation. The words appear to have been adopted from company law in the United States. The words have been explained as follows:

> "Technically, merger is limited to a statutory procedure whereby one of the constituent companies takes title to the assets of the other one, which in turn loses its existence by operation of law. If none of the constituent companies remains, but instead a new entity is created into which they are merged, the process is called consolidation." 111

6.14 These forms of statutory "merger and consolidation" are unknown to Ontario law. The words are used by the legal profession on occasion in a non-technical manner to describe the actual result of business combinations, e.g.

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108 See Professor Louis Loss - Securities Regulation, 2nd. ed., Boston, 1961 at p. 521, where he explains the rationale behind the "no sale" rule.

109 Wheat Report p. 280 *et. seq*.

110 Para. 6.21 *et seq*.

111 Cases and Materials on Corporations, Baker and Cary, 3rd. edition, Brooklyn, 1959, at p. 1435.

where one group of shareholders is left rather than two[112] or to describe acquisitions other than statutory amalgamations[113]. Assuming adequate investor disclosure, and subject to the rules regarding resale, our recommendations are intended to bring order and clarity to this exemption[114].

6.15 The word "re-organization" is found in both section 19(1)8 ii and section 19(1)9, both of which are included in the exemption from the prospectus requirements in section 58(1) of the Act. Section 19(1)8 ii speaks of "a trade in a security whether of its own issue or not that is distributed or issued by a company to holders of its securities as incidental to a bona fide re-organization...". Section 19(1)9 requires the involvement of another company since it exempts "a trade in a security of a company that is exchanged by or for the account of such company with another company or the holders of the securities of such other company in connection with ... a re-organization of either company...".

6.16 "Re-organization" is used in the definition of "arrangement" in section 95(1) of our Corporations Act to include a "reorganization of the authorized capital". This type of "reorganization" is provided for by sections 33(1)(d) to (i) inclusive of our Corporations Act as well as section 19(1)8 ii of the Securities Act. The word was also considered by the British Columbia Court of Appeal in Rex v. Santiago

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112 See "Corporate Re-organizations and Amalgamations" by D.G. C. Menzel, Q.C., at p. 273 in Developments in Company Law, op. cit. footnote 14.

113 See "Corporate Acquisitions - General Considerations" by J. Thomas English, Chapter 19 of Studies in Canadian Company Law, Ziegel, ed., Toronto, 1967. The author states at p. 604 "...the terminology in this area of company law is confusing."

114 While we are directing our attention to the investors the implementation of the Kimber Report has resulted in more adequate shareholder protection. It is hoped that this movement will continue.

Mines Limited[115] where the Court quashed a conviction for acting as a broker without registration on the basis of an exemption involving "a trade in its own securities by a company in the course of the reorganization of the company ..."[116] "Re-organization" is also akin to what is known as "reconstruction" in English law[117]. Professor Gower states that re-organization is employed when only one company is involved and the rights of its investors are varied[118].

6.17 The Ontario Corporations Act in its definition of "arrangement" in section 95(1) includes:

> "... a reconstruction under which a company transfers or sells or proposes to transfer or to sell to another company the whole or a substantial part of its undertaking for a consideration consisting in whole or in part of shares or securities of the other company and in which it proposes to distribute a part of such consideration among its shareholders of any class or to cease carrying on its undertaking or the part of its undertaking so transferred or sold or so proposed to be transferred or sold ...." 119

Take-over Bids

6.18 Apart from the exempt offers previously dis-

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115 [1947] 1 D.L.R. 642 (B.C.C.A.), per Sidney Smith J.A. at p. 648: " 'Reorganization' is a word of vague import. It is not a word of art and has no technical meaning in law. It is a commercial rather than a legal term ...".

116 Robertson J.A. and Bird J.A. dissenting. The reorganization consisted of increasing the authorized capital and issuing the newly authorized securities to the company president and to financial agents.

117 See Sidney Smith J.A. at p. 648 in the Santiago Mines case, op. cit.

118 Modern Company Law, Gower, 3rd. ed., London, 1969 at p. 615.

119 Section 22(1)m of the Corporations Act requires shareholders' approval for the sale of assets similar to statutory amalgamation. See paragraph 6.11. Section 243(1) provides the company cannot be voluntarily wound up without shareholders' approval. Section 95 provides for the court supervision of an "arrangement" which includes a sale of assets for shares and the distribution of those shares on winding-up.

cussed we recommend no change in the exemption from registration where a take-over bid is made in accordance with the provisions of Part IX of the Act. In the case of a share exchange the equivalent of prospectus disclosure must be made to the shareholders of the offeree company[120].

<u>The Resale of Securities Resulting from Business Combinations and Take-overs</u>

6.19 To this point we have been concerned specifically with the security holders of the companies involved in business combinations. In a variety of ways they receive some protection because of the provisions of existing corporation law or, in the case of take-over bids, the Act. But the area of our concern in this study has been for investors generally including security holders who may not receive adequate information by our standards under the laws of the incorporating jurisdiction.

6.20 Currently it is the view that the securities distributed through the exemption provided by section 19(1)9 and section 58(1) result in an exempted primary distribution to the public. Subject only to the securities not forming part of a control position they can be resold without further qualification. We are equally anxious that restrictions on resale be kept to a minimum. However the proliferation of acquisitions has forced us to the conclusion that there should be adequate information concerning such business acquisitions and combinations. These facts must be made available to investors generally before the securities issued or resulting from the combinations are permitted to be freely distributed. However the restrictions recommended are consistent with those generally applicable in our proposed continuing disclosure

120 See section 94 of the Act. See also Chapter VII.

system.

RECOMMENDATIONS

6.21 (1) The issuance of the securities through the revised exemptions recommended below are not conditioned on the issuer being a reporting company. The resales by the recipients of securities in both reporting and non-reporting companies should be prohibited until:

(a) a timely amendment is filed by a reporting company, at least 28 calendar days have passed from the filing of the amendment and there is no "selling effort"[121];

(b) in the case of a non-reporting company, a cornerstone prospectus is filed;

(c) in the case of reporting companies which have combined to form a new entity, a cornerstone prospectus for the new entity is filed; or

(d) an exemption is obtained under the revised section 59.

Under clause (c) resales would be permitted after 28 days providing there is no "selling effort"[121].

6.22 (2) We recommend that the nature and scope of the present section 19(1)9 be redrawn to give it clarity and certainty as follows:

> "a trade in a security of a company that is exchanged by or for the account of such company with another company or the holders of the securities of such other company in connection with

121 See para. 4.16 *supra*.

(a) a statutory amalgamation or arrangement,

(b) any statutory procedure under which one company takes title to the assets of the other company which in turn loses its existence by operation of law, or under which the existing companies merge in a new company, or

(c) a take-over bid as defined in Part IX."

6.23 (3) As discussed in paragraphs 6.03 to 6.05 many of the section 59 applications dealt with by the Commission arose through the desire of the issuer to acquire control or assets in consideration of securities through an "exempt offer" within the meaning of section 80(b)(i) and (iii). Our overwhelming experience is that the vendors neither desire nor need prospectus disclosure. The problems flow from questions of material changes in the affairs of the issuer resulting from the acquisitions. The vendors naturally wish to be free to resell. We therefore recommend that specific exemptions be provided for the private share exchanges or the issuance of shares for assets paralleling the existing exemptions in section 80 and section 19(3) as follows:

Section 19(1)9a:

"a trade in a security of a company in connection with an offer to purchase shares by way of private agreement with less than fifteen shareholders, or an offer to purchase all of the shares in a private company."

Section 19(1)9b:

"a trade in a security where the purchaser is a company in consideration for a portion of or all of the assets of any person or company if the fair value of the assets to be sold is not less than $100,000."

6.24 (4) The present legislation provides no clear cut exemption for the situation where a *bona fide*

prospector sells claims to a mining exploration company in return for securities[122]. The legislation should cater for this common situation through a specific exemption logically in section 19(2) along the following lines:

"12b. securities issued by a mining company in consideration for mining claims,".

Before these shares are eligible for resale they must be subject to an escrow agreement in accordance with existing Commission policies. This must be provided for in the revised section 58.

6.25 (5) On occasion applications are made under section 59 to permit a company to settle outstanding liabilities through the issuance of additional securities. The applications, which are comparatively rare, are usually granted. Because they are infrequent and if generally exempt would provide obvious opportunities for less scrupulous individuals, they should continue to be left for section 59 applications.

6.26 (6) So far as the exemption from section 35 is concerned it has been submitted that a distinction should be drawn between the new exemptions recommended, 19(1)9a and 9b, and the amended 19(1)9 on the basis that the exemption contained in clause 9 envisages only situations where there would be adequate shareholder disclosure and as a result adequate investor disclosure. It may be that the information available prior to the proposed corporate changes will normally provide adequate disclosure, and, as has been suggested, any period of escrow no matter how short will discourage the classes

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122 The "promoter" vendor is dealt with in Chapter VIII, para. 8.08.

of corporate changes and arrangements exempted. However, in the interests of consistency and adequate disclosure, we have concluded that the brief uniform restrictions, as set out in paragraph 6.20, should apply to all securities issued without hindrance under the amended and the new exemptions. Statutory procedures in other jurisdictions do not necessarily ensure adequate investor disclosure in Ontario. Thus uniform restrictions regarding securities of non-reporting and reporting companies which have been earlier suggested be added to a completely revised section 58 should apply equally to securities issued under these amendments.

CHAPTER VII

TAKE-OVER BIDS

Introduction

7.01 Our take-over bid legislation, Part IX, is based on Part III of the Kimber Report. This provides for a code of fair dealing between the parties by setting out time limits and other conditions. It also distinguishes between cash and share tenders. As to the time, when the bid is for less than all of the equity shares of a particular class, it fixes a maximum time of 35 days during which the offer may be kept open. All the shareholders tendering under the offer must be dealt with equitably. Where the number of shares being sought is less than the whole the taking up by the offeror must be pro rated amongst those tendering. Where the consideration offered is changed during the course of the offer the purchaser is required to pay the same price to those shareholders whose shares have already been taken up[123].

7.02 Between May 1st, 1967 and December 31st, 1969, 87 take-over bid circulars were filed with the Commission[124]. The provisions of the Act are considered to be a matter of contract involving offerees residing in Ontario. While exempt offers and take-over bids both give some concern the legislation, as the first of its kind, provided a forward step. The source of acquisitions, both through take-over bids and exempt offers, provides the background against which our conclusions are based.

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123 Sections 81 and 83 of the Act.

124 Appendix VII contains an analysis of these circulars made for the purpose of the study.

Oppression of the Minority

7.03 During the course of our study three take-over bids attracted particular public comment. The first of these involved Canadian Breweries Limited. The second involved Windsor Raceway Holdings Limited. More recently the competition for control of Maple Leaf Mills Limited gained prominence. There have been others. The equitable principles, the questions of "fairness", are raised through the exemptions contained in section 80(b). We shall be considering these in more detail commencing at paragraph 7.06 and following. For the moment let us consider the philosophical question which is always raised after a competition for control between relative giants. The minority shareholders find themselves at a loss, because of the competing claims or the atmosphere of uncertainty, to know the best course to follow. They must rely on their advisors. In the United Kingdom it has been suggested ultimate relief for the minority shareholder is afforded through section 210 of the Companies Act of 1948[125]. Subsection 1 permits an application to the court by, "any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) ...". The 1967 Interim Report of the Select Committee on Company Law of our Legislative Assembly rejected this concept in its Chapter VII dealing with "Duties and Responsibilities of Directors"[126]. This becomes important when one considers the position of the large or majority shareholders in such a power struggle and the question of whether they

125 Companies Act, 1948, 11 and 12, Geo. 6, c.38, as am. 1967, c.81.

126 1967 Interim Report of the Select Committee on Company Law, Ontario Legislative Assembly, 1967, at p. 60.

should have some legal obligation to the minority shareholders[127]. The "oppression of the minority" concept is one to be left for corporation law.

7.04 Individually the members of the Committee are far from having closed minds on this subject. We have suggested amendments which we feel will alleviate the situation in which the minority shareholder now finds himself. We shall also note that he has a flexibility of choice which may not be appreciated by the less sophisticated shareholders. We are loathe to recommend the easiest and least flexible solution, to prohibit all "exempt offers", requiring all acquisitions to be made through circulars and all offers to be made <u>pro rata</u> to all shareholders. We do consider it in paragraph 7.08 and elsewhere. Such a conclusion would reduce incentive to a common denominator, including the incentive to control, manage, build, and then divest to take the benefit of those efforts. The solution providing equality is simple. The result of such a solution would be profound.

<u>Definition of Take-over Bid</u>

7.05 Through the definition provided in section 80(g) the Legislature has in effect declared that an attempt to obtain more than 20% of the outstanding shares of a company, including the offeror's present holdings, would be deemed to be a bid for effective control of the company. While the figure of 20% may have been arbitrarily selected our examination of Canadian acquisitions suggests that it is a realistic one. It is for this reason we have recommended that the definition of "control" in section 1(1)16 ii, "primary distribution to the public", should be amended for certainty

127 This presumes that change of control is comprehended in the phrase "company's affairs".

to deem in the absence of evidence to the contrary that holdings of 20% of the voting shares materially affect control. The Canadian Breweries take-over eloquently demonstrated that holdings of less than 20%, even in a relatively widely held Canadian company, could no longer assure effective control. As in the United States, control of the proxy solicitation machinery no longer guarantees control of a widely held public company. We therefore recommend no change in the definition itself.

"Exempt Offer" - Statutory Definition

7.06 The definition of "take-over bid" specifically excludes "exempt offers". These are found in section 80(b) and are defined to include the following:

> " (i) an offer to purchase shares by way of private agreement with individual shareholders and not made to shareholders generally,
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> (ii) an offer to purchase shares to be effected through the facilities of a stock exchange or in the over-the-counter market,
>
> (iii) an offer to purchase shares in a private company or in a public company that has fewer than fifteen shareholders whose last address as shown on the books of the offeree company is in Ontario, two or more persons who are joint registered owners of one or more shares being counted as one shareholder, or
>
> (iv) an offer exempted by order of a judge of the High Court designated by the Chief Justice of the High Court made pursuant to section 89 ...".

"Private Agreements"

7.07 Dealing first with the problems raised by clause (i) we have already suggested in paragraph 6.23 of Chapter VI that a new exemption be provided from the registration and prospectus requirements of the Act and, in paragraph 6.21,

that resale of the securities be prohibited until a timely amendment is filed and 28 calendar days have elapsed.

7.08 The exemption raises the question as to whether some special liability or responsibility should result when the purchaser through a private agreement pays a premium over the market price. In this connection we have considered the approach taken through the so-called "City Code" in the United Kingdom developed by the City of London Investment Committee to govern take-overs[128]. Under it the directors who effectively control as well as controlling shareholders represented on the board should not sell that control without obtaining the buyer's undertaking to extend a comparable offer to the remaining shareholders. This condition has in fact been required in a number of cases by Canadian controlling shareholders[129]. The U.K. rule may be waived "in very exceptional circumstances" as to which the City Panel must be consulted in advance.

7.09 This rule in the City Code has a most appealing appearance of fairness. On the other hand, as noted in paragraph 7.04, it does move further down the road towards removing all incentive for entrepreneurship. The control person is subjected to insider liability. The draft Business Corporations Act (Bill 125)[130] forecasts more stringent restrictions on the conduct of management. The concept of oppression of the minority has been rejected by

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128 The City Code on Take-overs and Mergers, 13 pages, March 27, 1968, available from the Secretary, Issuing Houses Association, St. Albans House, Goldsmith Street, London, E.C. 2.

129 See Appendix VII at p. 8.

130 The Business Corporations Act, 1968, Bill 125, 1st Session, 28th Legislature, Ontario, 1968.

the Select Committee[131] in favour of statutory standards. While the recent cases give evidence of a falling out or lack of rapport between insiders, we have not yet concluded that control persons have so abused their positions as to require special treatment as a matter of securities legislation. Accordingly we find no reason to recommend deviating from the conclusions reached in paragraph 3.12 of the Kimber Report that as to questions of fairness of treatment as between shareholders this is a matter for corporation law and the courts. Securities legislation may then follow the lead given.

7.10 There is an inconsistency between item (i) and item (iii) which we recommend be removed to coincide with our recommendation in paragraph 7.16. At some point the number of private agreements suggest a general offer. We suggest they be restricted to fifteen.

Market Purchases

7.11 The second class of exempt offer, purchases in the market place, have been scrutinized not only in the light of the Canadian Breweries take-over but other acquisitions in which the take-over involved both a circular and purchases in the market place. The theory of the exemption is straightforward. No special effort is made to force the offeree shareholder to sell. He bases his decision on the market price of the securities and, when a formal take-over bid is outstanding for part of the shares, may be influenced into taking the lower market price by the fact that he can dispose of all and not merely part of his holdings.

7.12 While the Committee agrees that this exemption

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131 Op. cit. footnote 30.

should be continued we have concluded that the fact that a material change of control is occurring or is about to occur in the target company is an important item of investment information. It is within the basic objectives of the Commission's "timely disclosure" policy[132]. We have considered the methods of achieving this at some length. In the United States recent amendments to the '34 Act have barred take-overs in the market place without disclosure[133]. The "City Code" requires that the offer should first be placed before the board of the offeree company or its advisors[134]. Although trading is permitted through the London Stock Exchange for all the outstanding shares, the purchases must be reported to the Exchange on a daily basis and made public. We are suggesting another solution.

7.13 We have concluded that the "insider" whose holdings reach 20% as the result of market purchases should be required, as a matter of timely investor information, to report the fact of his purchases within three days of reaching 20%. In this, and in other connections, we have examined the definition in section 108 which, in subsection 1(c)(ii), speaks of anyone who "beneficially owns, directly or indirectly, equity shares of a corporation carrying more than 10 per cent of the voting rights attached to all equity shares of the corporation for the time being outstanding...". We recommend that the excuse for delay in reporting built into the concept of ownership should be removed by deeming the purchaser to own the shares on the day the market order

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132 Op. cit. footnote 23.

133 Section 13(d)(1) of the '34 Act and Regulations 13d-1 through 4 inclusive passed thereunder. Regulations adopted in Release 34-8370, July 30, 1968 (as amended).

134 Op. cit. footnote 128.

is executed. Any excuse for delaying reporting will be removed. We further recommend that the three day reporting requirement should continue as each additional 5% is achieved, i.e. 25%, 30% etc. The question of intention to acquire control was considered and rejected on the basis that purchases, even when effected through far flung nominees, are more certain of compilation than an intent which can only be crystallized with certainty once 50% has been exceeded.

7.14 The question of whether there should be the equivalent of a take-over bid circular available once the purchaser achieved 20% was considered and rejected.

7.15 Uncertainty does arise where the offeror states in the take-over bid circular that it intends contemporaneously to purchase in the market and will reduce the number of shares it will take through the take-over bid by the number it has purchased in the market. This, among other things, led us to consider prohibiting market purchases while a formal take-over bid is outstanding. While recommending against the latter we do recommend that for certainty, where the offeror elects to purchase in the market as well as through a take-over bid, he must announce his intention in the circular and shall be prohibited from reducing the minimum number of shares he will take under the offer by the shares purchased in the market.

<u>Limited Offer to Purchase</u>

7.16 Section 80(b)(iii) exempts offers to all the shareholders of a private company or to public companies having fifteen shareholders of record in Ontario. We see no reason to interfere with the exemption so far as private companies are concerned. However, since we have recommended limiting clause (i) to fifteen offers the second part of this

exemption appears redundant.

Exempting Order

7.17 In the light of the discretion vested in the Commission through section 103 as to proxies and proxy solicitations, section 116 as to insider trading, section 131 as to financial disclosure, and section 59 as to primary distribution it is suggested that application for an exempting order under section 89 be permitted to the Commission rather than to a High Court judge.

Review of Take-over Bid Circulars

7.18 While the conditions which led to the Kimber recommendation that there be no pre-offering review of take-over bid circulars have altered considerably, particularly in the light of the timely disclosure policies, the present flexibility is important. Our study has led us to conclude that take-over bid circulars for the most part have been responsibly and accurately prepared. In other areas we have recommended timely amendment without regulatory review. It is preferable that there be a clear statement as to the requirements with adequate sanctions and penalties to deter violation of those requirements. Here, as elsewhere, surveillance and enforcement are necessary adjuncts.

7.19 The take-over bid circular is, to the offeree, the equivalent of a prospectus. We therefore recommend that it should be approved by the directors, signed and certified in the same fashion presently required for a prospectus under section 52 of the Act and accompanied by a certified copy of the resolution of the board approving its filing and distribution. For surveillance purposes it should be accompanied by a cross-reference sheet similar to that presently required

by section 17 of the regulations to the Act. Since the circular must be sent to the individual offerees we recommend that there be a statutory right of rescission or withdrawal similar to that found in section 64 of the Act coupled with the civil liability and the defences available through section 141.

Contents of the Take-over Bid Circular

7.20 One of the suggestions made was that the offeror should be required to declare his purpose or business intention in attempting the acquisition. The harm which would follow from such a requirement is incalculable and the benefit questionable. It would invite deceit and not candour. The American experience to date shows the results of acquisitions are seldom those originally intended, let alone those forecast.

7.21 Where the right of appraisal or acquisition exists, that is either the right of the minority shareholders to apply to the courts for orders requiring their shares to be purchased or the right of the majority shareholder to acquire the minority shares such as is permitted by section 128 of the Canada Corporations Act[135], these rights should clearly be set out in the circular.

7.22 We examined several situations where a tender offer was made and at the same time the offeror was purchasing securities of the same class in the market. We touched on this in paragraph 7.15. The City Code[136] permits this when the tender offer is for all of the outstanding shares providing the offeror makes adequate disclosure of

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135 R.S.C. 1952, c.53, s.128,as am.

136 *Op. cit.* footnote 128.

his market transactions. The S.E.C., in Rule 10b-13 recently adopted[137], prohibits purchases in the market place so long as the take-over bid is outstanding. In our consideration of these two approaches, and others, we arrived once again at the standard of adequate disclosure on a timely basis. This is the 20% rule recommended in paragraph 7.13. Where the offeror intends also to purchase through the market he should be required to clearly declare his intention in the circular which will enable the offeree to choose between selling all of his shares at the market price or tendering at what would likely be a higher price in anticipation that only a portion of the shares he tendered would be accepted. To afford some certainty in this decision, as stated in paragraph 7.15, we would prohibit any reduction in the tender offer of the minimum number of shares the offeror would take under the circular. The offeror, under the previous recommendation, would only be required to report his purchases in the open market when they reached 20% and would not include, for the purpose of this reporting, the number of shares tendered in response to the circular which had not in fact been taken up.

<u>Right of Offeree to Withdraw</u>

7.23 Section 81.3 permits the offeree to deposit and then withdraw his securities "until the expiration of seven days" from the date of the bid. The cautious investor will withhold depositing his shares to await developments, including a circular, from the directors. Where the bid is for less than all of the voting shares it must remain open for a minimum of 21 days and a maximum of 35 days[138]. The purpose

137 Regulation 10b-13, passed pursuant to s. 10(b) of the '34 Act, effective November 10, 1969, Release No. 34-8712.

138 See s. 81.4 and s. 81.5 of the Act.

of the seven day withdrawal period is to enable the over-anxious tenderer to withdraw his shares in the light of a counter offer. There appears to be no reason to change it. The original offeror is entitled to some reasonable protection.

7.24 Not infrequently the original offer is amended in the face of a counter-offer. Although section 83(1) ensures that everyone depositing will get the higher price, the terms of the offer have been amended in the light of changing circumstances by the offeror. We have concluded that any change in the offer whether for part or all of the shares, excepting the extension of time for acceptance contemplated by section 81.5, for the purpose of section 81.3 under the changed circumstances the parties tendering would be permitted a further seven days from the date the amendment is mailed to them to withdraw. Section 82 would also be amended to coincide with an amended section 81.3.

"Market Out" Clauses

7.25 On occasion an offeror includes in its tender offer what are known as "market out" clauses. These escape clauses give the offeror a very substantial discretion to withdraw its offer during or even at the end of the offering period regardless of whether or not it has received the minimum number of shares tendered for. These clauses are not responsive to defensive tactics of the offeree's board of directors. They are appropriate to an underwriting in which the dealer assesses the market before going firm on his commitment. We recommend that such escape clauses be prohibited in take-over bids. The offeree is committed to sell his shares once they are tendered and the period of withdrawal has run. The offeror ought to be similarly

committed subject to his share objective being achieved.

"The Equity Shares of a Class"

7.26 Section 81 speaks in several places about offers "made for less than all the equity shares of a class owned by offerees". The restrictions as to time therefore do not apply when the offer is for all the equity shares of a class. Recent experience demonstrates that inequities can develop when there is more than one class of equity shares and the offer is for all of a particular class or classes. The result seems inconsistent with the equitable doctrine, pro rata acceptance, based on paragraph 3.17 of the Kimber Report and found in section 81.7. We believe that where the offer is for less than all of the voting shares of all classes the time limits placed presently on offers for less than all of a class should apply. Requiring that an offer be pro rata across classes of equity shares would be unreasonably restrictive on the offeror however. The terms and conditions attaching to various classes differ and the offeror should be free to elect as to which class or classes it wishes to purchase.

Directors' Circular - Offeree Company

7.27 Section 86 requires the directors to forward to each of their shareholders a directors' circular where they wish to either recommend acceptance or rejection of the bid. A number of submissions suggested that the directors' circular be mandatory in every case, setting out a breakdown by directors as to how each voted, what their particular interests were and their reason for making or refusing to make specific recommendations. After careful consideration we have concluded that there ought not to be such a universal

requirement. We are disappointed to note however that only 46 directors' circulars were deposited in response to the 87 take-over circulars filed between May, 1967 and December, 1969[139].

7.28 Ancillary to this was the question as to whether the present provisions in effect prohibit the directors or a director from making any comment short of a circular recommending acceptance or rejection of the offer. If there is doubt about this then section 86 should be clarified permitting a communication to the offerees from a senior officer of the offeree company, indicating the offer is under study by the board if such is the case and that a directors' circular will shortly be forthcoming setting out the board's position. This circular could suggest that the offerees defer depositing their shares until the directors' circular arrives.

7.29 We have noted occasions where a particular officer or director has offered comments either in support of or against a particular bid. While we feel that he should be free to do so it is also our recommendation that he should do so in the form of a circular setting out, amongst other things, his reason for accepting or rejecting the offer, his trading including those securities which he directly or indirectly owns or controls, the details of any private agreement he has for the sale of these shares, and any understanding as to his future employment and perquisites should the take-over succeed.

7.30 In passing we note that from our appraisal of the limited number of directors' circulars filed it is obvious that the shareholders are not always swayed by the position

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139 See Appendix VII at p. 7.

taken by their management[140]. While we would like to see the directors take a position more often, where there is not a substantial unanimity among them we do not feel it appropriate to force them into the role of investment advisers.

Identity of the Cash Bidder

7.31 The Kimber Committee in paragraph 3.18 recommended that the cash bidder should not be forced to reveal his identity. In 41 of the 87 take-over bids cash was the sole consideration and in only 3 of these was the identity of the cash bidder concealed[141]. It was submitted that the identity of the bidder may be an important piece of investment information in considering whether to continue to hold or sell shares when the offeree might otherwise have no present intention of selling his shares. On the other hand, as the Kimber Committee concluded, with the identity of the bidder concealed the offeree would be unswayed by any factor excepting his assessment of the price offered in relation to the market price and the company's long term prospects. The recent amendments to the '34 Act require the cash bidder to be identified.

7.32 Where the take-over bid is for less than all of the outstanding shares we have concluded the offeree is entitled to know the identity of the cash bidder with whom he might become associated. Where the bid is for all of the shares we recommend no change in the present law.

Time Limits for Offeree Taking Up the Shares Deposited

7.33 Section 81 provides that where the bid is for less than all of the equity shares of a class the offer shall

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140 *Ibid.*

141 See Appendix VII at p. 6.

not remain open for longer than 35 days. The shares deposited in response to that offer must be taken up and paid for within fourteen days of the last deposit day. There are no equivalent provisions when the offer is made for all of the shares of a class. In theory at least the offer might remain open indefinitely and the offeree who tendered his shares, after the seven day withdrawal period has run, would find himself locked in indefinitely.

7.34 Two solutions suggest themselves. In the first of these, the offeree would be free to withdraw after a stipulated minimum period of 35 days had elapsed unless his shares had been accepted by that time. Secondly where the offeror has declared that he wishes to purchase all of the shares, at the expiry of the maximum 35 day period he should be required to purchase all of the shares tendered or abandon his offer and return the securities tendered forthwith. The latter requirement commends itself to us. In the normal case where the offer is for all the shares the offeror commits himself to take up all the shares offered after the seven day withdrawal period elapses. Where the offer for all has some condition attached, on all the shares being tendered there appears to be no reason for permitting the offeror's obligation to take up and pay for the shares to extend for any longer period than that permitted for a partial offer.

Extension of Insider Liability to Take-overs

7.35 We have carefully considered the submissions made that the insiders of the offeror company should be deemed to be insiders of the offeree company for the purpose of insider liability for a period extending back six months from the date of the take-over bid. We have also examined the converse proposition, that the insiders of the offeree should be deemed

to be insiders of the offeror for a similar period. In the end result we have been unable to satisfy ourselves that such an extension would meet any need. The abuses appear to lie as much in take-overs which are announced but never formally proceeded with.

RECOMMENDATIONS

7.36 In summary the recommendations made as to changes in Part IX of the Act are as follows:

(1) The number of "private agreements" which may be entered into pursuant to section 80(b)(i) should be limited to fifteen. (Para. 7.10).

(2) Section 80(b)(iii) should be amended by deleting any reference to public companies and confining it to offers for securities of private companies. (Para. 7.16).

(3) As to market purchases we have concluded that while no restrictions should be placed on them a person having contracted for 20% of the equity shares through market purchases should be obliged to report this through a special type of insider trading disclosure made within three days of the purchase. The reporting should be based on the contract to purchase and section 108 should be defined to deem the purchaser to be the owner for reporting purposes at the time of the contract. The obligation to report within three days will continue each time an insider's holdings increase by 5%. (Para. 7.13).

(4) Under section 81.7 the offeror should be prohibited from reducing his <u>pro rata</u> purchases by the number of shares purchased in the market. (Para. 7.15).

(5) In the interests of consistency, the power to grant exempting orders in section 89 should be transferred to

the Commission. (Para. 7.17).

(6) There should be no regulatory review of take-over bid circulars (para. 7.18) but the circular should be approved, certified and signed as with a prospectus, should be accompanied by a cross-reference sheet, and since the document is delivered to the offeree a statutory right of rescission (section 64) should apply coupled with civil liability (section 141) identical with that attached to a prospectus. (Para. 7.19).

(7) Where the right of appraisal or acquisition exists the offeree should be advised in the take-over circular of his rights and the offeror should advise the offeree where he intends exercising any right he may have. (Para. 7.19).

(8) Where the offeror intends to purchase in the market his intention must be clearly set out in the take-over circular (para. 7.22). As noted in (4) he should be prohibited from reducing his pro rata purchases by the number of shares purchased in the market. In addition, as recommended in (3), he would be obliged to make the special insider trading report when his market purchases coupled with his other holdings, apart from the securities tendered, amounted to 20% of the equity shares, and for each 5% upwards thereafter.

(9) Where an offer is amended, section 81.3 should be amended to permit the offeree an additional seven days from the date the amendment is mailed to him to withdraw the securities already tendered. (Para. 7.24).

(10) An addition should be made to section 81 prohibiting any conditions added by the offeror to the offer excepting the right to withdraw on the failure of the offerees to

tender the minimum number of shares of particular classes he was willing to accept. (Para. 7.25).

(11) Where the offer is for less than all of all classes of equity shares it should be subject to the same statutory restrictions as are applicable currently when the offer is for less than all of a particular class of equity shares. (Para. 7.26).

(12) Section 86 should be clarified so as to permit a senior officer to advise the shareholders when the board is considering sending a directors' circular by suggesting their shares not be tendered until a communication is received from the directors. (Para. 7.28).

(13) Section 86 should also make it clear that a particular officer or director is free to offer comment for or against a particular bid providing he also details his own interest. (Para. 7.29).

(14) Where the take-over bid is for cash and is for less than all of the outstanding equity shares we recommend that the cash bidder be identified. (Para. 7.32).

(15) In the case of offers for all of the equity shares the offeror should be obliged at the expiry of 35 days to commence accepting and paying for the shares tendered or abandon his offer. (Para. 7.34).

CHAPTER VIII

EXEMPTIONS GENERALLY

The Impact of Continuing Disclosure

8.01 In Chapter II we have concluded by recommending the creation of two classes of companies, referred to as "reporting companies" and "non-reporting companies". In Chapter III we consider the concept of "public" in the light of the present legislation, concluding in paragraphs 3.20 and 3.21 that the inclusion of the word "public" in the definition of "distribution" was redundant. This conclusion is based on the premise that the legislation intends to protect everyone.

8.02 In the chapters which followed we examined the important exemptions to which our attention was directed by our terms of reference. These were "private placements" and "exempt purchasers", "business combinations" and "take-over bids". (We have also considered the problems raised by "control persons".) We concluded that adequate protection for the investor could be provided in a continuing disclosure system with these specific exemptions integrated. It is next necessary to examine the remaining exemptions from the prospectus requirements set out in subsections 1 and 2 of section 58, which in turn refer us back to the specific exemptions in section 19. We shall attempt to apply the "need to know" test and then move on to deal with the problem of how the specific exemptions can be provided for.

Underwriter Exemption - Sections 58(1) and 19(1)6

8.03 "Underwriter" is defined by section 1(1)32 of the Act. Section 6(1)(d) provides that no person or company shall

act as an underwriter without registration as an underwriter, broker-dealer or investment dealer or unless it is a bank. Section 19(1)6 enables the issuer to "trade" with an "underwriter" without registration to trade. Since the definition of "trading" in section 1(1)31 is broad this enables the issuer to negotiate with various underwriters. Section 58(1) exempts such trades from the prospectus requirements of section 35.

8.04 This exemption requires no change. In paragraph 2.28, we recommend that under specific circumstances the underwriter should be able to distribute to non-exempt purchasers through an offering circular or prospectus depending on whether it is a reporting or non-reporting issuer respectively. This will be accomplished by prohibiting resales by the underwriter.

8.05 Commencing at paragraph 5.17 we have already considered the possibility that exempt purchasers and private placees might be used to avoid the restrictions placed on underwriters through Exchange or Commission policy, including such matters as the maximum offering prices, and method of distribution. This is a surveillance and enforcement problem however.

Trades by a Company to its own Security Holders - Sections 58(1) and 19(1)8

8.06 There are three sub-clauses in this exemption. Each of these relates to trades by an issuer to its own security holders, i.e. distribution of its own securities by way of stock dividends, a distribution or issue of its own or other issued securities incidental to a *bona fide* reorganization or winding-up, or trading pursuant to a rights issue made initially to its own security holders. Applying

the "need to know" concept there appears to be no reason to interfere with the present arrangement concerning the issuance or distribution of the securities or the rights to the securities. However, in order to ensure adequate disclosure generally, we recommend that the resale be prohibited in the case of a reporting company for 28 days following the filing of a timely amendment disclosing the facts. We would recommend that the reporting company be permitted to file the amendment as soon as it is committed to the distribution whether by way of stock dividend, re-organization or winding-up, or a financing through a rights issue. Since it would normally take longer than 28 days for the legal and administrative details to be completed before the actual distribution of the rights or the securities, there is little likelihood of delay. Resale of securities of non-reporting companies would be stopped.

Trading to Employees - Sections 58(1) and 19(1)10

8.07 While the American case which enunciated the "need to know" philosophy was based on the need of particular classes of employees for prospectus disclosure[142] Canadian securities legislation generally and our Act in particular have exempted the trades completely. Subject as it is to the restriction that the trade should not be encouraged by the expectation of employment or continued employment no problems have arisen. It is desirable that employees should be readily permitted to invest in the company in which they are employed. Certainly as to a reporting company they will have much more information available. As to resale, in order that we treat the exemptions consistently we would recommend that employee options or an employee stock participation plan should be a matter for timely

142 *Supra*, paragraph 1.26.

amendment and that employees should be prohibited from re-selling the securities taken down under the plan for 28 days after the timely amendment is filed. The most practical plan would be to file the timely amendment 28 days before the option or the stock purchase plan becomes effective. In the case of a continuing plan, after the initial filing the regular reports would show the changes and they would be included in the annual statement. Effectively there would be, as now, no restrictions on resale for reporting companies. There would be a prohibition for non-reporting companies.

"Promoters"

8.08 Having rejected the continued use of the word "public" in relation to the exemptions, the result might be that the founders or "promoters" of a company would find it impossible to purchase shares in the company they seek to found. To avoid this patently absurd result a specific exemption will now be required. We suggest the present definition of "promoter"[143] be used in this exemption.

Section 19(2) and Section 58(2)

8.09 The twelve classes of exemptions provided for in these subsections are directed to securities of certain kinds of issuers as well as to certain kinds of securities which are exempted completely from the registration and prospectus requirements of the legislation. They involve securities issued by any government, including those of municipalities and school boards. They exempt debt securities guaranteed by one of the closely supervised financial institutions, e.g. banks, and the Ontario licensed loan and trust and insurance companies. There are securities issued by institutions or

143 See s. 1(1)18 of the Act.

companies which, as a matter of public policy, it is not intended to bring under the regulatory scheme including those issued by entities supervised elsewhere such as co-operatives and credit unions. Commercial paper, mortgages and like securities, with some qualification, are also exempted. The prospector and the prospecting syndicate is exempted although the syndicate agreement is substituted for the prospectus through the exemptions and section 34.

8.10 In making this recommendation we are mindful of our earlier conclusions that everyone shall be deemed to require prospectus disclosure unless a specific exemption is found in the Act[144]. In this way we avoided any problem which flows from an attempt to define the word "public" in the sense we believe it to be intended in the Act. Since subsection 2 of section 19 is concerned with kinds of securities rather than the kinds of persons or transactions dealt with in subsections 1 and 3, and since as a matter of public policy these are exempted completely from the regulatory scheme we did find it necessary to pursue the meaning of "public" further in connection with this subsection. Most of the problems have arisen in connection with trading in the securities of private companies. The courts seem to encounter little difficulty in dealing with the word in a given situation. Thus apart from the examination of the case law already undertaken in Chapter III, particularly paragraphs 3.12, 3.13 and 3.14 we have not found it necessary to explore further.

8.11 "Public" is found in clauses 4, 5, 9 and 12. With the word "public" removed from the definition of "distribution" (which it is recommended replace the present

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144 Chapters II and III are preoccupied with this.

"primary distribution to the public") the exemptions as they stand will if anything become more meaningful.

RECOMMENDATIONS

8.12 In summary our recommendations are as follows:

(1) The "underwriter" exemption in sections 58(1) and 19(1)6 should be continued with any resale by the underwriter prohibited. This will require the filing of an offering circular or a prospectus depending on whether the issuer is a reporting or non-reporting company, pursuant to the equivalent of the present section 35.

(2) No change is recommended as to the trades by a company to its own security holders defined in section 19(1)8. However, as to resale, in the case of a reporting company 28 days should elapse from the filing of a timely amendment. In the case of a non-reporting company resale would be prohibited.

(3) The employee exemption in section 19(1)10 should be continued. The right to resell in a reporting company will be based on a timely amendment setting out the option or the details of the stock purchase plan, with a 28 day delay following the filing of the amendment. In the case of a continuing plan after 28 days have elapsed from the initial filing, subject to the required regular reports set out in the recommendations in Chapter II[145], the employees will be free to resell. Resale of the securities of non-reporting companies would be prohibited.

(4) A simple definition exempting trades in the securities of a company to the promoters thereof should be added

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145 See para. 2.18 et seq.

to section 19(1) and section 58 with a prohibition on resale in section 58 for securities of non-reporting companies, and the standard restrictions, e.g. timely amendment, plus a 28 day delay coupled with no selling effort for a reporting company.

(5) No substantive changes are recommended in the exemptions presently provided for in section 19(2) and section 58(2). Prospectuses are not presently required for these.

CHAPTER IX

ACCOUNTING FOR AND DISCLOSURE IN BUSINESS COMBINATIONS AND ACQUISITIONS

The Objective

9.01 Much of the criticism directed towards acquisition minded companies has been aimed at the allegedly unrealistic market prices of their securities[146]. The market price of such securities appears to be based on price/earnings ratios applied to earnings per share which in turn can be influenced by the differences in earnings which result from using different methods of accounting for the acquisitions[147]. This criticism has emanated primarily from the United States. However at the time our study was established there was concern that the methods were being used in a similar fashion to account for acquisitions by acquisition minded Canadian companies[148]. A major objective of the Committee has been to determine if such was the case here and to ensure adequate disclosure by such companies so that their securities may be valued by the market in a more informed manner.

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146 As explained in para. 1.08 supra a conglomerate company is a company with diversified classes of business. We are, however, concerned with companies which make frequent acquisitions whether or not such acquisitions will cause the companies to become diversified.

147 The artificial values result from investors continuing to apply a high price/earnings ratio to earnings increments resulting from acquisitions, which should really carry a lower multiple.

148 This is apparently the case according to the Joint Study at p. 42; the Report of the Joint Study is described at para. 1.06 supra.
See also "The Chain Letter Revisited" by Marvin M. May, Financial Analysts Journal, May-June, 1968 at p. 113 and "The Merger Movement Rides High" by Gilbert Burck, Fortune, February 1969 at p. 81.

9.02 Two subjects allied with this objective are (a) the disclosure of earnings per share on a uniform basis, and (b) the disclosure of information by diversified companies on a basis that is meaningful to the investor. It is important that the investor should be able to distinguish clearly between growth resulting from acquisitions and internal growth in actual earnings. Our recommendations are aimed at achieving this end regardless of the accounting method for the time being adopted and regardless of the manner in which diversification was achieved.

Accounting for Business Combinations and Acquisitions: Pooling of Interests and Purchase Methods

9.03 A business combination or acquisition can be accounted for either as a purchase or as a pooling of interests. The difference between the two methods is set out in Research Bulletin No. 48 of the American Institute of Certified Public Accountants[149]:

> " For accounting purposes, a purchase may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.
>
> " In contrast, a pooling of interests may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all of the ownership interests (150) in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent

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149 Issued in 1957 by the Committee on Accounting Procedure, American Institute of Accountants, New York at para. 3; Bulletin No. 48 revised Research Bulletin No. 40 published in 1950 which gave official recognition to the two methods of accounting.

150 "As used in this bulletin the term 'ownership interests' refers basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects."

corporations, either directly or through one or more subsidiaries..."

A consolidated financial statement using the purchase method of accounting for an acquisition or combination is prepared by (a) adding the value of the assets of the acquiree, which may be their book value or revalued to be greater than book value, to the book value of the assets of the acquiror, (b) adding the book value of the liabilities of the acquiror and acquiree, (c) increasing the capitalization of the consolidated company by the market value of the acquiror securities (debt or equity) issued to effect the combination or acquisition[151] and (d) if the increase in capitalization is greater than the increase in net assets reflecting this premium as an acquisition premium or goodwill on the assets side of the balance sheet[152].

9.04 In the pooling method of accounting the assets of the acquiror and acquiree are simply added at their book value as are their liabilities. Unlike purchase accounting the earned surplus of the acquiree company is carried forward to the consolidated statement. The important difference however is that the consolidated shareholders' equity is increased only by an amount equivalent to the net book value of the acquiree company's assets. This means that no acquisition premium or goodwill would appear as a difference between the increase in shareholders' equity and the book value of the acquiree company's shares. An example of the application of both methods of accounting to one acquisition is provided in

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151 Many purchases are for cash in which case the requisite portion of the asset cash disappears from the consolidated balance sheet.

152 On occasion, rather than premium or goodwill there may be "negative" goodwill where the market value of the consideration is less than the net book value of the assets acquired.

Appendix VIII[153].

The Evolution of the Pooling of Interest Concept

9.05 Bulletin No. 48 referred to earlier, established guidelines for determining the continuity in the combining companies appropriate for a pooling of interests accounting for the combination. Such guidelines are: (a) the relationship between the interest of the owners in the combining corporations and their interests in the combined corporation should be in proportion for a pooling; (b) similar considerations exist with respect to voting rights; (c) changes in the respective ownership rights shortly after the combination indicate a purchase; (d) sale of part of one of the combining businesses following the combination suggests a purchase; (e) continuity of management through the combination must exist for a pooling; and (f) if the size of one of the combining corporations is clearly dominant a purchase is indicated. The Bulletin provided that all of the guidelines need not be followed.

9.06 These guidelines were continually eroded in application. This erosion was recognized in 1965 by the Accounting Principles Board of the A.I.C.P.A. in Opinion No. 6 which stated that Bulletin No. 48 should be continued "as an expression of the general philosophy for differentiating business combinations that are purchases from those that are poolings of interests", but emphasized that "the criteria set forth in paragraphs 5 and 6 of Bulletin 48 are illustrative guides and not necessarily literal requirements[154].

153 For a background discussion of accounting for business combinations see the Report of the Joint Study, Chapter I. See also the discussion in "Accounting for Business Combinations", D.W. Lay, Canadian Chartered Accountant, November 1967 at p. 329.

154 "Opinions of the Accounting Principles Board - 6".

Earnings Per Share: "Pooling" vs. "Purchase" Accounting

9.07 It was in the period following the 1965 Opinion that the number of acquisitions in the United States increased in frequency. We noted this trend briefly in Chapter I in connection with the impact on market price of acquisitions and the accounting methods[155] used by the acquiror. For such companies to make acquisitions it was most helpful if their securities were highly priced in the market and this was frequently the case. High market prices meant, of course, that fewer securities would have to be issued to make an acquisition. Market price is strongly influenced by earnings per share. Earnings per share may be enhanced by using either method of accounting in these respects:

(1) When two companies are pooled the earnings of each company for the complete financial year in which the pooling occurred are added together and are accounted as the earnings of the pooled company for that complete financial year, (even if the acquisition was made on the last day of such year). When one company purchases another only the earnings of the purchased company for the remainder of the financial year can be included in the earnings of the two companies consolidated by the purchase. In determining earnings per share and therefore the number of shares outstanding for pooled companies, all of the shares issued to make the acquisition will be added to the shares outstanding because the shares will be considered to have been outstanding for the complete financial year. In the purchase method of accounting only a weighted average of shares issued to make the

155 Paras. 1.08, 1.09 and 1.10.

acquisition will be added to shares outstanding. If the acquiror has a higher price/earnings ratio than the acquiree and shares are issued to make the acquisition and the acquisition is accounted for as a pooling, mathematically the earnings per share of the combined companies must increase. The market will then usually place a higher value on the shares of the combined companies. This process - the chain letter effect - can be repeated. This effect is demonstrated in the example in Appendix VIII.

(2) When one company purchases another the difference between the cost to the purchaser of such purchase and the value assigned to the net assets acquired is usually shown on the balance sheet of the consolidated company as goodwill. In Canada this goodwill may (1) be written off against retained earnings immediately, (2) be amortized gradually against future earnings, or (3) left on the balance sheet. Method (2) will, of course, cause a decrease in future earnings per share. Methods (1) and (3) are attractive to the issuer because the effect on future earnings is avoided[156]. It is apparent that with respect to future earnings methods (1) and (3) influence earnings in the same manner as if the acquisition was accounted for as a pooling.

9.08 The pooling of interests method became the method of accounting for business acquisitions or combinations in

156 Method (1) is not acceptable in the U.S.A. which in part accounts for the popularity of pooling in the U.S. This is discussed in the Report of the Joint Study at p. 38. Another reason is discussed at p. 23 of that Report.

a majority of the acquisitions which occurred in the U.S.A.[157] The concern expressed by the S.E.C. and other regulatory authorities as well as the A.I.C.P.A.'s own concern for establishing some uniformity in the use of the two methods has led to a recent series of conferences sponsored by the A.I.C.P.A. in which draft opinions of the Accounting Principles Board on accounting for business acquisitions and combinations have been considered. Guidelines to replace those in Bulletin No. 48 are expected shortly.

Accounting for Business Combinations in Canada

9.09 Until recently very little published information was available in Canada outlining the methods used by Canadian companies in accounting for acquisitions and combinations. This void has been significantly reduced by the Report of the Joint Study to which we referred earlier. In its consideration of business combinations the Joint Study used a sample consisting of 410 of the 498 industrial companies listed on the Toronto Stock Exchange as at December 31, 1968. Of the 410 companies, 254 made acquisitions, in total, 998 acquisitions[158]. The Joint Study discloses that 52 of these 998 acquisitions were accounted for as poolings[159], approximately 5%, and that the number of poolings is increasing with time.

9.10 The Joint Study concluded with respect to

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157 Fortune magazine estimates that the pooling method accounted for only 30% of all mergers in 1965 but more than 60% of mergers in 1968; Fortune, February 1969 at p. 82.

158 Report of the Joint Study at p. 10. 129 of these 410 companies were studied in some detail, representing 507 acquisitions. A sample of 27 companies, 15 using the purchase method and 12 using the pooling method in at least one acquisition, representing 114 acquisitions, was used for in-depth study.

159 Id. at p. 17.

poolings that:

> "... virtually all transactions satisfied the primary criterion of a pooling - that is the medium of exchange in the transaction was almost completely voting common shares. When tested against the other three criteria for pooling, no more than 50% of the transactions we examined would have met the historical tests for relative size, management continuity or industry similarity. We conclude therefore that there has been a rather liberal interpretation of the standards which have been used in practice for deciding whether a transaction qualified as a pooling of interests. However, while the pooling criteria were interpreted rather liberally, we still found that only about 5% of the [998 acquisitions] were accounted for on this basis. 160

9.11 We discussed earlier the three methods of treating the acquisition premium which normally results in accounting for an acquisition using the purchase method. The Joint Study found in its analysis of 93 business combinations treated as purchases that in 63 combinations all or part of the acquisition premium was recognized as goodwill, (the other 30 revalued assets). In 12 of these 63 cases the goodwill was systematically written off against income. In the other 51, 31 retained the goodwill on the balance sheet and 20 wrote it off to surplus accounts[161]. The Joint Study concludes from this data that:

> "The implication is clear that comparability of earnings data among these companies was difficult if not impossible to determine since in most cases the information concerning disposition of excess was not clearly spelled out in published annual reports." 162

<u>The Joint Study Acquisition Equation</u>

9.12 From an investor's point of view the conclusion which is apparent from the Report of the Joint Study is clear.

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160 *Id.* at p. 46.

161 *Id.* at p. 34.

162 *Id.* at p. 46.

Earnings may depend (a) upon whether an acquisition is accounted for as a pooling or purchase and there are no clear guidelines as to when either method is appropriate; and (b) earnings may depend upon the treatment accorded goodwill or the acquisition premium when the acquisition is treated as a purchase and again there are no clear guidelines as to the circumstances appropriate for a particular treatment. An investor may be influenced in his actions simply by the accounting method used. The need for consistency in accounting for acquisitions is obvious. Establishing such consistency will require serious consideration of accounting principles. The Committee is anxious to convey its concern that such consideration be undertaken by the accounting profession immediately and that consistent accounting principles be developed as soon as possible. The Committee notes that this concern is shared by the Joint Study which urges the C.I.C.A.[163] to resolve the questions of accounting principles involved no later than December 31, 1970. Such a time limit is reasonable.

9.13 The Committee is of the view that some interim recommendation is possible which, without suggesting accounting principles, will neutralize any tendency to mislead which the particular method of accounting for an acquisition may have. This can be achieved through appropriate disclosure which must be made by the acquiring company at the time of the acquisition. The disclosures should be required only when the acquisition is <u>material</u> to the acquiror. In developing the content of such disclosure we have been impressed by the suggestion of the Joint Study concerning publication of what is termed the "complete

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163 *Id*. at p. 50.

acquisition equation"[164]. This equation accounts "for the purchase price involved in a transaction in two ways: first as represented by the value of the net assets acquired and second as represented by the sources of funds used as payment in acquiring these assets."[165]

9.14 The equation is outlined as follows:

"The Acquisition Equation

Purchase Price (A)	= Net Assets at Book Value on Predecessor's Records	(N)
	$\pm$ Adjustments of (N) to "Fair Value"	(F)
	$\pm$ Premium or Discount Related to Goodwill	(G)
Purchase Price (A)	= Working Capital Payments,- e.g. Cash, Bank Loans, etc.	(W)
	+ Long Term Debt	(D)
	+ Preferred Stock	(P)
	+ Common Stock	(C)

$$\therefore \quad N \pm F \pm G = W + D + P + C$$" [166]

9.15 An example of the acquisition equation taken from the Report of the Joint Study follows:

"On your company acquired 95% of the outstanding common shares of Company Limited, a food processor located in British Columbia. The transaction which was accounted for on a purchase basis involved the following payments:

Cash	$ 1,000,000
7% cumulative redeemable preference shares	5,000,000
50,000 common shares, no par value, valued on the basis of market price at dates of issue	5,000,000
Total purchase price	$11,000,000

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164 Id. at p. 50.

165 Id. at p. 10.

166 Ibid.

The following net assets were acquired in the transaction:

Tangible net assets at book value on predecessor's records	$ 6,000,000
Increase in value of land and other non depreciable assets	1,000,000
Increase in value of buildings to be depreciated over the remaining life	1,000,000
Goodwill - to be amortized against income over its estimated life - estimated by management to be approximately 25 years	3,000,000
	$11,000,000 [167]

9.16 This example reflects an acquisition accounted for using the purchase method. The Joint Study discusses the equation for a pooling in the following passage:

> " A similar acquisition equation would be published for transactions treated as poolings of interests although of course there would be no revaluation of assets acquired. On the other hand, for pooling transactions the disclosure of the acquisition equation should include details as to the number of shares issued and the book value of these shares together with an indication of the market value of the shares so issued. In this way the reader would be able to calculate the total market value of the transaction and judge for himself the amount and effect of the potential goodwill which was not recognized in the transaction, having regard to any special valuation problems that may result from the new share issue.
>
> " We believe that full disclosure of the acquisition equation in all acquisition transactions would greatly improve the standards of management's accountability for merger transactions in the present environment. It would provide the interested reader and analyst with the factual information required to assess the financial effect of the transaction and since it was reported after the fact should not inhibit merger negotiations in any way." [168]

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167 Id. at p. 50 .

168 Ibid.

9.17 We recommend the adoption of the acquisition equation. We would envisage disclosure being made as in the example set out above. Note that in addition to disclosing the constituent elements of the purchase price disclosure is made of the following items:

(1) the date of the acquisition,

(2) the type of acquisition, i.e. shares, assets or statutory amalgamation,

(3) the name and business of the acquired company,

(4) the method used to account for the acquisition, and

(5) if goodwill results from the acquisition, the treatment of such intended by the acquiror.

9.18 In addition we recommend that disclosure be made of the proportion of the total securities outstanding represented by the securities issued to make the acquisition (if any). If the acquisition is accounted for by the pooling method an earnings history for at least two years should be furnished as though the companies had been "pooled" for the years covered by such history. This history should be set out alongside an earnings history for the acquiror alone. This will enable the reader to observe the impact upon earnings attributable only to the acquisition. Finally earnings per share in accordance with the recommendations in the next part of this chapter should be disclosed.

<u>National Uniformity</u>

9.19 We have adopted the acquisition equation not

only because of its authoritative source but because of our interest in national uniformity. If the suggestion of the Joint Study is adopted by the C.I.C.A. then disclosure according to the equation will become the practice supported by members of the C.I.C.A. across Canada.

Advantages to the Investor

9.20 The information required to be disclosed will enable the investor among other things

(a) to observe that his company may be diversifying through the acquisition,

(b) to analyse how the acquisition has been financed and what has been acquired,

(c) to see the method used to account for the acquisition and how the "purchased" goodwill will be treated, and

(d) to observe the impact upon earnings attributable to the acquisition.

9.21 The disclosures would be required as part of the material required of reporting companies in the timely amendment concerning acquisition. In order to have this information available to investors as soon as possible, we further recommend that the Director consider requiring this standard of disclosure in prospectuses through the exercise of his powers under the Act. In the case of reports other than prospectuses we support the suggestion of the Joint Study "...that Canadian corporations involved in business combinations voluntarily agree to the publication of the complete acquisition equation in the first published annual report after the transaction was completed...."[169]

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169 *Id.* at p. 50.

This will also lead to consideration of amendments to Part XII of the Act[170].

Disclosure of Earnings per Share in Earnings Statements

9.22 It was noted earlier that acquisitions may be financed by debt securities with some equity sweetener such as conversion rights or warrants attached[171]. The denominator in the earnings per share index when such securities are issued is the same before and after the acquisition if earnings per share are reported simply on the basis of outstanding equity shares. The numerator on the other hand will increase by the amount of the earnings of the acquired company reduced by interest charges on the new securities. The earnings per share figure reported on this basis may be misleading because it reflects the acquired earnings but not necessarily all of the cost of the acquisition, i.e. the dilutive effect, since the financing was paid for by securities convertible into equity.

9.23 The Accounting and Auditing Research Committee of the Canadian Institute of Chartered Accountants published

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170 We have been made aware of a problem which exists when a company wishes to issue no par value shares as the consideration in an acquisition which is to be accounted for as a pooling of interests. Under section 31(3) of The Corporations Act the directors allot and issue the shares for the consideration fixed by the directors acting in good faith and in the best interests of the company. If the directors can satisfy themselves in good faith that it is in the best interests of the company for the acquisition to be accounted as a pooling of interests then the consideration may be fixed at the book value of the property acquired. In order for the shares to be allotted and issued as fully paid the directors must pursuant to section 31(4) in good faith determine by express resolution that the acquired property is the fair equivalent of the consideration fixed. The fair equivalent will not normally be the book value of the acquired property but the market value. This problem may in part be remedied by inserting "at least equal to" after "transaction" in the second last line of section 31(4). The same problem is raised in the Report of the Joint Study in a footnote at p. 40 of its Report. We have referred the matter to the Companies Branch.

171 See discussion in para. 1.11 <u>supra</u>.

an exposure draft in July of 1969 on the reporting of earnings per share. Comments have been received by that Committee upon the exposure draft and we are advised that a final draft has been approved by that Committee. We understand that it is to be published shortly as a recommendation of the Accounting and Auditing Research Committee[172].

9.24 We are of the view that it is desirable to require the reporting of earnings per share in all financial statements which report earnings. Earnings per share reported on the basis of common shares outstanding should be supplemented by a report which reflects the existence of securities which may be converted into common shares. The C.I.C.A. recommendation will require calculation and disclosure of earnings per share both as basic earnings per share and as fully diluted earnings per share. We are content to recommend adoption of the C.I.C.A. formula.

9.25 One criticism made to us on reporting earnings per share on a fully diluted basis was that such an index may be misleading, presumably because there may be shares outstanding with some equity feature which will never be converted or exercised. While this may be misleading we feel it will be equally misleading to only disclose basic earnings per share. In the latter case there may be securities with an equity right attached which has not been exercised but which could at any time be realistically exercised. The investor has the right to examine both. He can attribute to each the weight he considers appropriate in arriving at his investment decision.

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172 Canadian Institute of Chartered Accountants, Research Recommendations, Section 3500.

9.26 We accordingly recommend that where earnings per share are required to be disclosed under the Act in financial statements that they should be disclosed in accordance with the requirements of the recommendation of the Accounting and Auditing Research Committee of the C.I.C.A. as published.

Disclosure by Diversified Companies According to Classes of Business

9.27 One of the major reasons for the trend towards more acquisitions has been management's desire to achieve diversification in business. Thus it has been fairly common for a small company carrying on one class of business to be absorbed by a large diversified company carrying on several classes of business. This absorption of single class businesses by multi-class businesses has resulted in a reduction in the information available to the investor. The large multi-class business may not prepare its financial statements to afford disclosure according to classes of business. It will ordinarily consolidate its statements with the result that the investor is unable to determine the contribution made to the whole by each class of business. The inability of investors to determine the contribution of each class of business and in many cases the efficiency of management in connection therewith has pointed to the desirability that class reporting be required.

9.28 In July of 1969 the Securities and Exchange Commission adopted amendments to the registration forms under both the '33 and '34 Acts to require reporting by product line by certain companies[173]. In the words of the Release the following disclosure must be made:

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173 Securities Act Release No. 4988 and Securities Exchange Act Release No. 8650, July 14, 1969.

"   Where a registrant and its subsidiaries are engaged in more than one line of business, the amendments require the disclosure for each of a maximum of the last five fiscal years subsequent to December 31, 1966, of the approximate amount or percentage of total sales and operating revenue and of contribution to income before income taxes and extraordinary items attributable to each line of business which contributed, during either of the last two fiscal years a certain proportion to (1) the total of sales and revenue, or (2) income before income taxes and extraordinary items. For companies with total sales and revenues over $50 million, the proportion will be 10 percent; for smaller companies, 15 percent. Similar disclosure is also required with respect to any line of business which resulted in a loss of 10 percent or more (or 15 percent or more for smaller companies) of such income before deduction of losses. Where the percentage test as applied to both sales and earnings contributions results in more than ten lines of business, the disclosure may be limited to the ten most important lines. Where it is not practicable to state the contribution to income before income taxes and extraordinary items for any line of business, the contribution to the results of operations most closely approaching such income is to be disclosed."

9.29 This requirement still leaves undefined the concept of what constitutes a "line of business". Before attempting a definition it became necessary to decide who should define "line of business", the regulator or management. On this question the S.E.C. has adopted the recommendation contained in a study prepared for the Financial Executive Research Foundation, Financial Reporting by Diversified Companies[174]. This study recommends that "management, because of its familiarity with company structure, is in the most informed position to separate the company into realistic components for reporting purposes"[175]. The S.E.C. implements this recommendation in the following words:

"... in view of the numerous ways in which companies are organized to do business, the variety of products and services, the history of pre-

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174 R.K. Mautz, New York, 1968.

175 Id. at p. 158 .

decessor and acquired companies, and the diversity of operating characteristics, such as markets, raw materials, manufacturing processes and competitive conditions, it is not deemed feasible or desirable to be more specific in defining a line of business. Management, because of its familiarity with company structure, is in the most informed position to separate the company into components on a reasonable basis for reporting purposes. Accordingly discretion is left to the management to devise a reporting pattern appropriate to the particular company's operations and responsive to its organizational concepts." [176]

9.30 In Canada no legal requirements for class reporting have been implemented[177]. However, the Federal Parliament has tabled amendments to the Canada Corporations Act initially in May of 1969 in Bill C-198 and more recently in October, 1969 in Bill C-4[178] which will implement a requirement for reporting by class of business. Section 16 of Bill C-4 will add a new section 120A, the class reporting requirement. This provision is taken from amendments to the U.K. Companies Act effected in 1967[179].

9.31 The reporting requirements of section 120A are triggered when a company carries on "businesses of two or more classes that, in the opinion of its directors, differ substantially from each other." This approach is consistent with the S.E.C. approach in allowing management to define class of business. Subsection 1 applies to a company without subsidiaries. Subsection 2 applies to a company which has

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176 Op. cit. footnote 173.

177 See an excellent discussion of current reporting requirements of diversified companies in "Financial Reporting by Diversified Companies - Part 1" by G. Mulcahy, Canadian Chartered Accountant, Oct. 1969 at p.286; Part 2 appears in the December 1969 issue of the same publication at p.444.

178 Op. cit. footnote 56.

179 Op. cit. footnote 125.

one or more subsidiaries and which prepares its financial statements in consolidated form.

9.32 The section will require by way of note to each financial statement a statement of

> "a) the proportions in which the amount of sales or gross revenue for that period, so far as stated in the financial statement in respect of that period, is divided among those classes of business; and
>
> b) as regards the business of each class, the extent or approximate extent (expressed in either case in monetary terms) to which, in the opinion of the directors, the carrying on of the business of that class contributed to, or restricted, the profit or loss of the company for that period."

9.33 The S.E.C. provides guidelines for the grouping of unimportant lines of business. Bill C-4 does not provide specific guidelines but apparently leaves such grouping to the discretion of management. According to the S.E.C. unimportant lines are those lines which contribute less than 10% by way of revenue or income if the company has more than $50 million in total sales or revenue; and for companies with less than $50 million in total sales and revenue such lines are those that contribute less than 15% by way of total revenue or income to the enterprise.

9.34 The Committee has discussed the question of reporting by class of business with shareholders, investors, management representatives and analysts and is satisfied that information reported according to class of business by diversified companies would be meaningful for investment purposes. We accordingly recommend that reporting by class of business be required by the Commission upon a date considered below.

9.35 Some of the diversified companies which discussed this question with the Committee indicated that they thought

that figures prepared on the basis of class of business might be misleading. This would be especially true for the net income figures because certain costs which are not easily attributed to different classes may have to be attributed in a rather arbitrary manner or reported separately. We have been advised that the Accounting and Auditing Research Committee of the C.I.C.A. has assumed responsibility for the matter. We recommend that before requiring the reporting of income by class of business the Commission should await the recommendations of the C.I.C.A. Committee. The Commission may then look for guidance to its Financial Advisory Board.

9.36 As an interim measure we recommend that the Commission implement a requirement patterned upon proposed section 120A that gross revenues only be reported by class of business in all statements requiring the reporting of gross revenue. Some provision should be made for grouping insignificant classes of business in this reporting requirement. We recommend therefore that for companies with more than $25 million in total sales and revenue only those classes of business contributing 10% or more to the consolidated gross revenue be reported and that for companies with total sales or assets of less than $25 million only those classes of business with 15% or more contribution to gross revenue be reported.

RECOMMENDATIONS

9.37 A summary of the recommendations follows:

(1) The questions involving purchase method versus the pooling of interest concept of accounting should be left to the accounting profession and, in particular, the study which may be anticipated by the Canadian Institute of Chartered Accountants.

(2) The problems of investor disclosure resulting from the use of either method can be resolved by requiring the information recommended in the Joint Study "Acquisition Equation" supplemented by additional facts (paras. 9.12 to 9.17).

(3) Where the pooling method is used this disclosure should also include an earnings history for at least two years as though the companies had been pooled (para. 9.18).

(4) These recommendations will require amendments to Part XII and will be required of a reporting company in the continuous disclosure system through a timely amendment (para. 9.21).

(5) Earnings per share should be reported both as basic earnings per share and as fully diluted earnings per share in accordance with the C.I.C.A. recommendation (para. 9.24). This can be adopted as a requirement under the present legislation as well as in the continuous reporting system.

(6) We recommend as an interim measure, pending the conclusions of a study being instituted by the C.I.C.A. (para. 9.30) that diversified companies be required to report gross revenue only by classes or lines of business, the grouping being the responsibility of management, with companies having gross sales and revenues exceeding $25,000,000 reporting those classes or lines of business contributing 10% or more to their consolidated gross revenue, while those having $25,000,000 or less reporting on the basis of contributions of 15% or more to gross revenue.

CHAPTER X

SUMMARY OF RECOMMENDATIONS

Chapter I: Introduction

In this chapter the concern is primarily with providing some background to the study. However there are a number of concepts, basic to securities regulation explained, on which much of this Report is premised:

1. The purpose of securities legislation is to afford some measure of protection to the investor so that he may invest with confidence, while taking into account the needs of the issuer of such securities.
2. Disclosure of current information about the issuer on a continuous and timely basis is one of the most important means of achieving this purpose.
3. This disclosure has traditionally been made in a prospectus which is required whenever the issuer is selling its securities to investors who need the information in the prospectus in order to make an informed investment decision.
4. Exemptions for the issuer from the requirement of a prospectus are available when the issuer sells its securities to persons who are able to protect themselves and who therefore do not need a prospectus in order to make an informed investment decision.
5. The recommendations in the Report have been

developed with an awareness of the general lack of liquidity in Canadian securities markets and with a view to improving the liquidity.

6. The importance of national uniformity in securities legislation is recognized and every effort has been made and will be made to involve the other securities administrators in the development of the recommendations in the Report.

<u>Chapter II</u>: <u>The Principle of Disclosure</u>

1. The trend in the disclosure requirements of our securities legislation has been to disclosure on a continuous and timely basis in order to better meet the needs of investors in our trading markets. It is recommended that the trend be completed with the implementation of a continuous disclosure system.
2. In order to enter the continuous disclosure system companies would file a standard prospectus with the Commission which would review the prospectus in the same manner as required by the existing legislation. Such companies would thereafter be known as "reporting companies".
3. Reporting companies would be required to file two basic types of reports:
   - (a) quarterly unaudited financial reports, and
   - (b) amendments to the basic information reflecting material changes in the company would be required within 10 days after the occurrence.

The less formal disclosure required under the timely dis-

closure policies of the Commission and Exchange would continue to provide timely information in the form of press releases etc. The company's continuous file would be updated annually with the filing of a document reflecting the changes which occurred in the issuer's affairs during the year. These reports would not be reviewed by the Commission on a pre-filing basis.

4. In circumstances ordinarily requiring a prospectus reporting companies would file with the Commission for review an offering circular. The offering circular would be a much simpler document than the prospectus.

5. Companies whose securities are listed or which qualify their securities (whether debt or equity) for distribution in Ontario or which are subject to Parts X and XII of the Securities Act will participate in the continuous disclosure system. In addition, companies, the trading in whose securities is disclosed in the proposed trading information system being established by the Investment Dealers Association, will be encouraged to participate in the continuous disclosure system.

6. Provision will continue for an application to be made to the Commission for an order exempting a company from the continuous reporting requirements.

7. The civil remedies of rescission and damages will apply to offering circulars. The regular reports and timely amendments will be subject to the offense provisions in the Securities Act and criminal offence provisions in the Criminal Code. The Commission has in addition other techniques at its disposal, such as suspension of trading, to ensure that accurate information is being disclosed on a timely basis.

8. Quick dissemination of the information disclosed in the continuous disclosure system is fundamental to informed investment decisions. To effect the dissemination reliance must be placed upon the brokerage community, the financial news media and commercial reporting services.

9. A clear distinction should be made between legislation aimed at protecting investors and legislation aimed at protecting shareholders. The former is securities legislation and the latter is company law. Legislation regulating the solicitation of proxies is shareholder legislation and should be confined to the Corporations Act. Lesgislation regulating insider trading, take-over bids and continuous disclosure is investor legislation and should be confined to the Securities Act.

Chapter III: Who are the Public?

The disclosure provisions of the Securities Act turn on the concept "primary distribution to the public". Disclosure is required in the form of a prospectus when securities are traded in the course of a primary distribution to the public. Several revisions to this concept have been recommended:

1. Primary distribution to the public should be replaced by the concept of a "distribution". Since the proposed regulatory scheme is all-inclusive with the residual discretion vested in the Commission the word "public" can be removed from the Securities Act. A distribution will require offering circular disclosure by reporting companies and prospectus disclosure by non-reporting companies.

2. Exemptions to this disclosure requirement will be codified in section 58(1) of the Act. In cases appropriate for an exemption but not within the specific terms of an exemption, application can be made under a revised section 59 for an exempting order.

3. Resale of securities issued under an exemption will be deemed to be a distribution (and subject to the disclosure requirements) unless three standard conditions are met:

   (a) the issuer of the securities under the exemption files a timely amendment to its continuous disclosure file reflecting the facts of the exempt issue;

   (b) the person taking the securities under the exemption holds the securities for a period of at least 28 days; and

   (c) such person does not use selling efforts in order to resell the securities.

4. Further exemptions from the disclosure requirements can be legislated as they become apparent to the Commission in its hearing of applications under section 59.

Chapter IV: Control Persons

Sales of securities in a company by a person in a position to materially affect control of the company are included in the present definition of primary distribution to the public and are included in the replacement for primary distribution to the public, "distribution". Some changes are suggested:

1. In order that a person holding shares in a company

will know with greater certainty whether he materially affects the control of the company, branch ii of the definition of distribution should be amended to provide that any person, company or combination thereof holding more than 20% of the equity shares of a company (the standard for control in the take-over bid provisions) shall be deemed, in the absence of evidence to the contrary, to materially affect control of the company.

2. A broad exemption from the offering circular disclosure requirements for sales of securities by control persons should be available if (a) the issuer of the securities is a reporting company, (b) 28 days have elapsed since the disclosure of the control position, (c) the sales are not accompanied by special selling efforts (as defined) and (d) the control person reports all sales within three days thereof in public insider trading reports.

3. Sales by control persons not meeting these conditions or for which another exemption is unavailable must be accompanied by an offering circular (or prospectus if the issuer is not a reporting company).

Chapter V: Exempt Purchasers and Private Placements

Companies can raise funds privately, i.e. without prospectus disclosure if securities are issued to exempt purchasers or if the issue of securities is a private placement. Changes are suggested in the use of these exemptions and in the disclosure made in connection with the use of these

exemptions.

1. Exempt purchasers should be subject to the same requirements as purchasers in private placements except for the stipulated minimum amount of purchase in private placements. Exempt purchasers must therefore purchase with an investment intent.
2. The exemption in section 58 from the disclosure requirements should be available only when exempt purchasers or purchasers in private placements purchase as principal although trust companies should be able to make investments on behalf of fully managed accounts.
3. The status of exempt purchaser will be renewed annually by the filing of a return reporting the use to which the status was put.
4. The exempt purchaser and private placement exemptions will only be available to issuers which are reporting companies which will be required to file a timely amendment to the continuous disclosure file describing the exempt issue (other than the identity of the purchasers). In addition each purchaser must file for the private use of the Commission, a copy of the existing Form 8 report at the time of the purchase and within 10 days of any resale a report with particulars of the resale.
5. Resale by the purchasers under the exemptions without an offering circular will be possible if 28 days have elapsed since the disclosure of the purchase through a timely amendment and if the resale is not accompanied by special selling

efforts. Furthermore purchasers under either of the exemptions must purchase with an investment intent. Quick resale by the purchaser might result in the purchaser being treated as an underwriter. The Commission will be able to maintain surveillance over the use of the exemptions through the reports required of purchasers under the exemptions.

Chapter VI: Business Combinations

Like the securities issued to exempt purchasers or under the private placement exemption, securities issued in business combinations are often issued under an exemption from prospectus disclosure. These securities should not find a way into the general trading markets until the fact of their issue is disclosed. The terms of the exemptions should also be clarified:

1. The regulation of trading in the securities in a business combination effected through a share exchange is uncertain. A special exemption for trading in shares in a share exchange acquisition from prospectus or offering circular disclosure should be provided if there are less than fifteen shareholders selling their shares or if the selling shareholders are selling all of their shares in a private company. The selling shareholders in such acquisitions are generally able to protect themselves and do not need regulated disclosure.
2. If assets of a company, instead of the shares in the company, are being acquired for securities, issue of the latter should be exempt from prospectus or offering circular disclosure if the fair value

of the assets being sold by the company is greater than $100,000. The selling company will generally not need prospectus or offering circular protection. The issue of securities by mining companies to acquire mining claims should also be exempt.

3. Resale of securities issued in the above acquisitions without a prospectus or offering circular will be possible only if the issuer of the securities is a reporting company, 28 days have elapsed since the filing of a timely amendment describing the issue of the securities under the exemption and the vendors of the securities do not use special selling efforts to effect the resales.

4. In addition to the exemptions described above section 19(1)9 as incorporated in section 58 provides an exemption for certain forms of combination generally regulated by corporation law. The terms of this exemption should be clarified so that trading in connection with such combinations can be done free of a prospectus or offering circular. These are a statutory amalgamation or arrangement, or any statutory procedure under which one company acquires assets of another which loses its existence or under which existing companies merge into a new company. The relevant corporation law should provide for the needs of the shareholder. However to ensure adequate disclosure to investors generally of the issue

of securities in connection with such acquisitions resale will be regulated in the same manner as in 3 above.

Chapter VII: Take-over Bids

1. Share exchanges which are not take-over bids, i.e. exempt or private offers, should be defined in the same terms as the exemptions from the offering circular or prospectus discussed in the previous chapter. Accordingly, such offers will include offers to shareholders in a private company and offers by way of private agreement resulting in not more than fifteen private agreements.
2. The exemption from the definition of take-over bid for offers effected through the market should remain. However, disclosure will be required in connection with such offers: a person who obtains 20% of the outstanding equity shares through market purchases will be required to disclose this fact in an insider trading report which must be filed within 3 days of reaching 20%; in addition, whenever a person increases his holdings by 5% through market purchases he will be required to report this fact in a similar fashion. Ownership in this context will exist when the purchase order is filled.
3. An offeror making a take-over bid who intends to purchase in the market must disclose this in his take-over bid circular and file reports in respect of such purchases in the manner discussed in 2 above. In addition if the offer is for less than all the outstanding equity shares, the offeror will not be able to reduce the number of shares required to be taken up under the terms of the take-over bid by those shares purchased in the market.
4. Orders declaring a proposed take-over bid to be an exempt

offer should be granted by the Commission rather than a judge of the High Court.

5. Take-over bid circulars should not be subject to pre-filing review by the Commission but the circular should be approved, signed and certified as is a prospectus and when sent to the Commission should be accompanied by a cross reference sheet. The civil remedies of rescission and damages should also apply.
6. Where the right of appraisal or acquisition exists the offeree should be advised in the take-over circular of his rights and the offeror should advise the offeree where he intends exercising any right he may have.
7. Where the terms of an offer are amended while a bid is outstanding, the offerees should have seven days from the date of the amendment to withdraw their shares.
8. Conditions in take-over bids should be prohibited with the exception that the offeror can withdraw on the failure of the offerees to deposit the minimum number of shares the offeror is willing to accept.
9. Offers open to less than all classes of equity shares should be regulated in the same manner as offers for less than the shares of one class of equity shares.
10. The only public communication by a director or the directors of an offeree company short of a directors' circular which should be permitted is that the board is studying the offer and is preparing a directors' circular and until the circular is distributed recommends that the offeree shareholders defer depositing.
11. Although directors' circulars should continue not to be mandatory, a particular director of the offeree company may make a recommendation concerning the bid if he also

provides the disclosures required in directors' circulars.

12. Where the take-over bid is for cash and is for less than all of the outstanding equity shares the identity of the bidder should be disclosed.

13. If the bid is for all of the shares of a class, at the expiration of 35 days from the date of making the offer the offeror should be required to take up all the shares deposited or abandon his offer.

Chapter VIII: Exemptions Generally

The exemptions from the prospectus other than those reviewed in Chapters V and VI were reviewed here to analyse them in light of the needs of the investor and to fit them into the continuous disclosure system.

1. The exemption for a trade to an underwriter should be continued but resale without an offering circular or prospectus should be prohibited.
2. The issue of securities by a company to its own security holders should be exempted as in section 19(1)8 but resale should be prohibited in the case of a reporting company until 28 days have elapsed from the filing of a timely amendment describing the issue, and prohibited in the case of a non-reporting company without a prospectus. Similar treatment should be accorded the exemption for issues of securities to employees of the issuer.
3. A new exemption should be drafted for the issue of securities to promoters of the issuer based upon the definition of promoter in the Act. The standard restrictions upon resale would apply to such securities.
4. The exemption in section 58(2) from the prospectus should continue for the securities in section 19(2).

Chapter IX: Accounting for and Disclosure in Business Combinations and Acquisitions

This chapter is concerned with improving the information which is disclosed to investors in connection with business acquisitions.

1. Rules concerning the use of the two methods of accounting for acquisitions, the pooling of interests and purchase methods, should be left to the accounting profession for formulation. Such rules can be anticipated from the Canadian Institute of Chartered Accountants on the basis of the recent study Business Combinations in the '60s: A Canadian Profile.
2. The problems of investor disclosure resulting from the use of the two methods of accounting for business acquisitions can be resolved by requiring disclosure based upon the "Acquisition Equation" designed in that study. The Equation will be supplemented with additional facts such as an earnings history for two years for pooled companies as though they had been pooled during the two years.
3. This disclosure will be required in the timely amendment to the continuous disclosure file of a reporting company when such a company makes an acquisition.
4. Disclosure of both basic earnings per share and fully diluted earnings per share in accordance with the recommendation of the C.I.C.A. Accounting and Auditing Research Committee should be required in statements of earnings required under the existing legislation and in the continuous reporting system.
5. Pending the conclusions of a study being undertaken by the C.I.C.A., diversified companies should be

required to report gross revenues by class of business. The determination of what constitutes a class of business is the responsibility of management. A test is suggested for determining the important classes of business.

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APPENDIX II

July 23, 1969

ONTARIO SECURITIES COMMISSION MERGER STUDY

In the weeks which have passed since the Merger Study was constituted some of the issues to be studied have been more specifically defined. This has come about from comments received from many of those solicited and from independent research. The following is an expanded form of our preliminary list of topics which sets out some of the issues before the Study in greater detail. It is being circulated to those persons who received an initial request for comments from the Merger Study and have indicated their intention of replying some time in the future as well as to those persons who have already made some suggestions to the Merger Study, many of which have been incorporated herein. The following list will serve as a reminder to those who have yet to submit their comments to the Study as well as a means of placing before those wishing to make comments a more specific list of the issues which the Merger Study will consider.

TERMS OF REFERENCE

> "In the light of present practices and conditions, to review and report upon existing legislation, regulations and policy relating to consolidations, amalgamations, mergers, re-organizations, take-overs, private placements and exempt purchasers, and related subjects, and generally to recommend what, if any, changes in the law appear desirable."

EXPANDED LIST OF TOPICS

1. Definitions (Ontario Securities Act)

(a) "Primary Distribution to the Public" - section 1(1)16

- should the existing definition and any decisions interpreting it be changed in any respect whatsoever

- should some objective standards be adopted for determining whether a particular distribution is to the "public" - such standards might relate to:

(i) the number of offerees
(ii) the relationship of the offerees to the issuer
(iii) previous association between offeror and offeree, i.e. close personal friendship, business association, custom or habit of trading in securities
(iv) the sophistication of the offerees
(v) the number of solicitations by the offeror
(vi) the dollar amount of securities being issued
(vii) the amount of information about the issuer publicly available and the currency of such information

- should some objective standards be adopted for determining whether securities form part of a block materially affecting control - such standards might relate to:

  (i) the percentage relationship between the block and total outstanding securities

  (ii) the relationship of the holder to the issuer or to directors or senior officers of the issuer

- should some objective standards be adopted permitting securities which form part of a control block to be sold without qualifying a prospectus after a minimum holding period - in certain percentage amounts - should there be a requirement that such sales be reported separately.

(b) "Exempt Purchasers" - section 19(1)3

- should the entire exemption in this clause be abandoned altogether (with or without the private placement exemption discussed below left as is)

- the exemption might be retained only for purchasers recognized by the Commission as "exempt purchasers" or only for the specific institutions named in the clause

- should an investment intent be required of exempt purchasers

- should parties using this exemption be required to report all purchases and any subsequent sales

- should a minimum statutory holding period be applied to all purchases made pursuant to this exemption - a provision might be made for resale of certain percentage amounts after a minimum statutory holding period

(c) "Private Placement" - section 19(3)

- should the investment intent requirement be replaced by a minimum statutory holding period after which resales of privately placed securities could be made - should a limit be placed upon the number of persons to whom resales could be made

- should resales of privately placed securities be governed by a set of objective rules permitting resales of securities of companies who have kept the public well informed with continuous regular and timely disclosure but forbidding resales in the absence of such disclosure

- should Form 8 requiring the reporting of private placements to the OSC by the vendor be changed to require reporting by the purchaser of privately placed securities of such purchases and any subsequent resales

(d) "Take-over Bid Definitions" - section 80

- do the exemptions from the definition of take-over bid, e.g. an offer to purchase shares to be effected through the facilities of a stock exchange or in the over-the-counter market, lead to many abuses which could be remedied by requiring such exempt offers to be subject to the disclosure requirements of Part IX of the Securities Act, or to some other disclosure requirement.

- the definition of take-over bid now applies to offers which will give the offeror more than 20% of the outstanding equity shares of a company - should this limit of 20% be altered

II. Exemptions from Registration and Filing

- section 19(1)9 exempts a trade in a security of a company that is exchanged by such company with another company or the holders of the securities of another company in connection with a consolidation, amalgamation, merger or re-organization - has this exemption from registration and filing been used by the legal profession in advising on the application of the Securities Act to mergers, etc. - in what circumstances

- does this exemption have any basis in policy for permitting the avoidance of registration and filing requirements

- if not, should it be repealed so that, for example, in an assets purchase the shareholders of the acquiree company would be provided with some form of disclosure concerning the affairs of the acquiror company

III. Disclosure

- should the Securities Act and its administration place more emphasis on expanded disclosure about a company's operations on a continuous regular and timely basis

- if greater emphasis should be placed on continuous reporting, at what intervals or times should reports be required, e.g. quarterly

- should the Securities Act and its administration place more emphasis on information about the distribution of or market in a company's securities

- should the present or an expanded proxy information circular be filed with the OSC for approval before being sent to shareholders

- should the information circular which accompanies a proxy solicitation be expanded to require more information to shareholders in the event that management is seeking shareholder approval of matters relating to a merger or acquisition

- in connection with a continuous reporting system, should a timely disclosure policy be legislated which

would require a company to disclose to its shareholders significant acquisitions or dispositions - if so, when should the disclosure be made, e.g. on the day when information relating to such eventuality is no longer confined to senior management of either or both companies involved, or upon the signing of a letter of intent between the parties to the acquisition or disposition, or upon the signing of a formal agreement between the parties to the acquisition or disposition, or on the day of closing of the transaction

- has the business community developed its own code of timely disclosure of material information to shareholders which affords sufficient protection to such shareholders to make more specific regulation by the OSC unnecessary

- should statutory civil liability provisions similar to those imposed on persons certifying the prospectus be placed on persons responsible for annual and semi-annual reports, proxy information circulars and timely disclosure releases

IV. Take-over Bids - Part IX

- under Part IX as it currently exists a bidder must simply deposit a take-over bid circular with the OSC at the time it is distributed to shareholders of the offeree company

- should the legislation be amended to require the OSC to review the take-over bid circular as it does with prospectuses filed prior to a primary distribution to the public

- should some form of "early notice" be legislated into the take-over provisions of the Securities Act which would require any person who has acquired over a defined period of time a certain percentage of the shares of a public company, e.g. 5% or 10%, to disclose to the company more information and on a more timely basis than is required by the present insider trading provisions of the Securities Act - if so, should this information include the identity of the acquiror and his plans to acquire control and to merge the company with the acquiror or any other associated company

- should a prohibition against trading by a take-over bidder in shares of the offeree company other than pursuant to the terms of the bid be legislated into the Securities Act

- should there be liability provisions for trading on the basis of inside information by insiders of an offeror in shares of the offeree and by insiders of an offeree in shares of the offeror

- under Part IX of the Securities Act it is open to the directors of the offeree company to distribute a directors' circular to shareholders of such company recommending acceptance or rejection of the take-over bid - should a requirement be legislated into Part IX

that some designated official of the offeree company be required to distribute a circular to shareholders of the offeree company, in the absence of a directors' circular, which would, for example, inform the shareholders of the offeree company of the operations of the offeree company, the time at which the offeree company first became aware of the take-over bid, trading by officials of the offeree company in the shares of the offeree company, and the interest of the officials of the offeree company in the offeror company

- should the identity of a take-over bidder who proposes to pay for the securities tendered in cash be disclosed in the take-over bid circular

- should the take-over bid circular disclose to the shareholders of the offeree company the plans of the offeror company for the offeree company

- should statutory civil liability provisions similar to those imposed on persons certifying the prospectus be placed on persons responsible for the take-over bid circular and directors' circular

- should a person paying a premium above present market price to the holders of sufficient shares to gain effective control of a company be required to pay the same premium or some compensation to minority shareholders - if so, how should the premium be dispersed among minority shareholders

V. Accounting for Acquisitions

- should there be reporting by a multi-industry company of sales and profits by divisions, classes, or "product lines" after an acquisition - how should the divisions be determined

- should a statement of earnings per share be included in the annual and interim statements (see recent C.I.C.A. proposal) - should earnings per share be reported on a fully diluted basis, (i.e. as if all convertible securities, warrants and options had been exercised) as well as on an undiluted basis

- should a prohibition or some restriction be imposed upon the use of the pooling of interest method of accounting for business combinations

- should goodwill be written off to retained earnings on acquisition, amortized to income or retained earnings, or carried forward indefinitely unless there is evidence of limited life

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Charterhouse Canada Limited	I. Monteith J. Rae D.L. Sinclair
The Chartered Institute of Secretaries	
Cobban, Woolley & Dale	D.C. Woolley, Q.C.
Canadian Life Insurance Association	

Davies, Ward & Beck	H.L. Beck R.A. Davies, Q.C.
Day, Wilson & Campbell	R.Y.W. Campbell
Mr. R.W.V. Dickerson	
Dominion Foundries & Steel Ltd.	I. Jamieson
Dylex Diversified Limited	J.F. Kay W. Posluns
Falconbridge Nickel Mines Ltd.	G.T.N. Woodrooffe
Farris, Farris, Vaughan, Wills & Murphy	C.F. Murphy
Fiscal Consultants Canada Limited	L.N. Watt
Fraser & Beatty	D.A. McIntosh, Q.C. J.A. Mullin, Q.C.
Fry & Company Limited	C.W. Goldring J.D. Grant
Mr. J.W. Gemmell, Q.C.	
Glens Falls Insurance Company	H.R. Lawson
The Goodyear Tire & Rubber Company of Canada Limited	K.E. Kennedy, Q.C.
Dr. Richard Gosse, Q.C.	
Professor P.J. Halpern	
Mr. C. Marshall Hames	
Mr. R.M.P. Hamilton	
Holden, Murdoch, Walton, Finlay, Robinson, Pepall	D.W. Falconer, Q.C.
International Factory Sales Service Limited	R.A. Smith
Investment Dealers' Association	
Mr. A.T. Lambert	
Manitoba Securities Commission	D.M. Peden, Q.C. R.B. Cantlie
McCarthy & McCarthy	P.G. Beattie J.W. Blain, Q.C. J.H.C. Clarry, Q.C. I. Douglas, Q.C. G.P.H. Vernon, Q.C. J.W. Walker, Q.C.

McConald, Currie & Company	M. Carscallen R. Cole R.B. Dale-Harris D.B. Morin D. Timbrell
Miller, Thomson, Hicks, Sedgewick, Lewis & Healy	J.A. Langford
Molson Industries Limited	D.G. Willmot
Mr. C.S.M. Mortimer, Q.C.	
Neonex International Limited	J.A. Pattison
Newman, MacLean & Associates	M. Neuman, Q.C.
Ogilvy, Cope, Porteous, Hansard Marler, Montgomery & Renault	J.G. Kirkpatrick, Q.C. P. Legrand
Ontario Chamber of Commerce	
Oshawa Wholesale Limited	R.D. Wolfe
Osler, Hoskin & Harcourt	H.P. Crawford, Q.C. H.C.F. Mockridge, Q.C.
Peat, Marwick, Mitchell & Co.	T.A. Hutchison
Power Corporation of Canada Ltd.	P. Desmarais C. Bruneau C. Frenette J. Leduc P. Martin E. Peck W.I.M. Turner
Precision Data Company Ltd.	D.P. Owen
Quebec Securities Commission	M. Lajeunesse, Q.C. E.D. Angers, Q.C. L. Cusson M. Cusson
The Royal Bank of Canada	G. Aitken J.F.E. Crabtree W.E. McLaughlin J.E. Morgan R.C. Paterson
Royal Trust Company	R. Brunelle J. MacQueen R. Otley J.S. Scholes H.W. Wickens
Mr. Peter Spark	
Mr. David A. Stevens	
Stitt & Baker	S.M. Sigel

Strathy, Archibald, Seagram & Cole	T.F.C. Cole, Q.C.
Sun Life Assurance Company	J.C. Gordon J. Harrison D. Horn M. Prescott A. Wirth
Thermatron Corporation Ltd.	A.R. Jacobs
Tilley, Carson & Findlay	A.S. Kingsmill, Q.C.
The Toronto Dominion Bank	G.R. Baker R.W. Korthals Dr. D. Peters S.G. Robertson
The Toronto Stock Exchange	
Tory, Tory, Deslauriers & Binnington	J.C. Baillie James Tory, Q.C.
Touche, Ross, Bailey & Smart	A.N. Phillips R.M. Rennie
Triarch Corporation Limited	A.G.S. Griffin
The Trust Companies Association of Canada	
George Weston Limited	G.E. Creber, Q.C.
The Winnipeg Supply & Fuel Company	F.E. Estabrook
Mr. F.G. Winspear	
Robert Woolley Shoe Company Ltd.	R.A. Woolley
Professor J. Peter Williamson	

APPENDIX IV

ECONOMIC BACKGROUND TO MERGERS AND ACQUISITIONS

Historical Background

Mergers and acquisitions[1] have always been an integral part of economic activity. They occur in increased numbers in times of economic prosperity and the wave recedes when the economy has lost its vibrancy.

To gain an understanding of the current wave of corporate mergers, we must look at the business, social and political environment in which these flourish.

In the United States of America the underlying factors in the first merger wave at the turn of the century were: the rapidly growing demand for mass-produced goods which destroyed local monopolies and markets, creating companies which became national in scope; expansion of cheap transportation facilities; technological advances of that period demanding large capital outlays. During this period a large number of companies in the basic industries were brought together through horizontal and vertical mergers. In 1890 the Sherman Act was passed to

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1 The term "merger" is used to describe a union of two previously separate firms through the acquisition by one of them of the whole or part of the assets or voting shares of the other; or the union of two or more firms through share exchange. The term"acquisition" describes a situation where one firm, maintaining its own identity, acquires other firms which may or may not lose their identity. The Take-over of Canadian Firms, 1945-61, An Empirical Analysis, by Grant L. Reuber and Frank Roseman, Special Study No. 10, Economic Council of Canada, the Queen's Printer, 1969, p. 11.

prevent further concentration of large economic units. In spite of this Act, merger activity continued to rise to a peak in 1899. After 1904 the American public began to demand a breakdown of trusts, and business itself was calling for a temporary halt in economic concentration. Time was needed by business to digest what already had been absorbed and also to gather strength for the coming storm, the severe economic recession of 1907. The Clayton Act was passed in 1914 in an attempt to supplement effective anti-trust enforcement with a scheme by which certain business practices likely to promote monopoly might be dealt with in their incipiency, at a stage early enough to prevent the emergence of the monopoly[2].

A favourable climate for a second wave of mergers was created by Post-World War I optimism. By 1926 a number of new industries had reached economic maturity: motion pictures, automobiles, public utilities. These industries were anxious to re-organize or merge. Acquiring companies took advantage of the rising securities market and were using newly issued securities in exchange for shares of acquired companies. During the depression years mergers continued to take place but at a significantly reduced rate. Large companies were absorbing small enterprises which found themselves in serious financial difficulties.

Since the end of World War II, the merger movement has continued upward without significant interruption. The United States Federal Trade Commission recorded the following number of mergers:

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2 Interim Report on Economic Policy, Economic Council of Canada, Ottawa, July 1969, Queen's Printer, p.35.

	Manufacturing and Mining Mergers				Trade and Services Mergers	
			Total Assets of Firms Acquired			
Year	No. of Mergers	Index	Millions of Dollars	Index	No. of Mergers	Index
1955	683	100	2,825	100	163	100
1956	673	99	2,777	98	236	145
1957	585	86	1,963	70	152	93
1958	589	86	1,435	51	195	119
1959	835	122	2,642	94	229	140
1960	844	124	2,326	82	250	153
1961	954	140	2,630	93	475	291
1962	853	125	2,990	106	471	289
1963	861	126	3,947	140	344	211
1964	854	125	3,670	130	454	278
1965	1,008	158	4,914	174	503	309
1966	995	146	5,416	191	411	252
1967	1,496	219	10,815	383	542	332
1968	2,442	358	15,200	535	1,148	704

Source: Staff Report of the Federal Trade Commission: Economic Report on Corporate Mergers, Washington, 1969, pp. 667 and 679.

The present merger policy of the U.S. Government stems from the 1950 Celler-Kefauver amendment to the Clayton Act, extending the restrictions to merge from horizontal to non-horizontal mergers, i.e. when a merger would result in substantial lessening of competition or create a monopoly. This was designed primarily to protect small independent enterprises from hostile take-overs by larger competitors.

The strong anti-trust government feeling supported by anti-trust legislation restricting horizontal and vertical

mergers, coupled with other economic forces, led to the spectacular growth of multi-product and multi-market companies in the U.S.A. which until 1968 had not been subject to the anti-trust legislation. However, the accelerating rate of merger activity in 1969 led the Department of Justice to issue Merger Guidelines[3] restraining conglomerate mergers as well.

Europe was relatively free of anti-trust regulations enabling cartels to flourish in the pre-World War II period. In Britain, after the war, The Restrictive Trade Practices Court was established in 1956. A decade later The Monopolies and Merger Act of 1965 introduced the principle that certain mergers should be liable to examination and, in the light of the public interest, either permitted, prohibited, or if already consummated, dissolved. In recognition of the positive aspects of mergers, the British Government passed The Industrial Re-organization Corporation Act in 1966. Two years later The Industrial Expansion Act implemented a positive policy towards mergers, with the result that mergers and acquisitions followed the more natural course in contrast to the exploratory ways which lead to the formation of large economic units in the U.S.A.

Canada's proximity to the U.S.A., on one hand, and its close economic, cultural and political ties with the U.K. on the other, plus its own economic structure carved out a unique Canadian approach to combines, competition and mergers.

Canadian anti-combines policy has been framed in terms of criminal law, first enacted in 1889, prohibiting conspiracies and combinations in restraint of trade. The

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3 Studies by the Staff of the Cabinet Committee on Price Stability, Study Paper Number 4, available at the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

first Combines Investigation Act was passed in 1910 setting up machinery for investigation of alleged offences under the original Act. This Act was amended in 1952. In 1961 further amendments were introduced into the Act, mainly referring to its administration. However, it must be stressed that this Act, up to the present, has been mainly thought of as a deterrent to price fixing and not as anti-merger legislation.

While comprehensive statistics on merger movement in the United States have been made available by the Federal Trade Commission, daily financial press and quarterly by W.T. Grimm & Co., in Canada there has not been available a similar record of business combinations. Although individual mergers received extensive coverage in the daily and financial press, a number of acquisitions of private companies by domestic or foreign corporations have not been recorded or publicized. The most comprehensive record and analysis of business combinations in Canada is contained in the Study entitled The Take-over of Canadian Firms. 1945-61.

The Annual Report of the Director of Investigation and Research of the Combines Investigation Act gives the number of business combinations for the period 1962 - 1968:

ACQUISITIONS[1]

Year	Total	Index	Foreign[2]	Index	Domestic[3]	Index
1955	134	100	56	100	78	100
1956	135	100	54	97	81	104
1957	103	77	35	62	68	87
1958	140	104	60	107	80	102
1959	188	140	66	118	120	154
1960	203	151	93	166	110	141
1961	238	177	86	154	148	190
1962	186	139	67	120	119	153
1963	133	100	37	66	96	123
1964	196	146	76	136	120	154
1965	229	170	70	125	159	204
1966	227	169	86	153	141	181
1967	246	184	85	152	161	206
1968[4]	389	290	159	284	230	295

(1) Figures for years 1955 to 1961 from Reuber-Roseman Study, p.32, and figures for years 1962 to 1968 from Report of Director of Investigation and Research Combines Investigation Act.

(2) Acquisitions involving a foreign-owned or controlled acquiring company.

(3) Acquisitions involving a Canadian-owned acquiring company.

(4) Preliminary figures.

Economic Climate of the '60's

To understand the increased merger activity of the 1960's, it is necessary to establish the economic setting. Dramatic economic growth has been characteristic of the 1960's. The GNP climbed steadily from $37 billion in 1960

to the estimated $79 billion at the end of the decade[4]. The population of 17,870,000 in 1960 passed the 21 million mark in mid 1969. Per capita income increased from $2,031 in 1960 to $3,248 in 1968. Index of industrial production (1961 - 100) climbed from 96 in 1960 to 166 in 1969. However the production index tells only part of the story. The most dramatic development in the 1960's has been the accelerated rate of technological changes not only in industrial production, but in the field of communication and in services which have required large capital outlays.

In the 1960's Canadians spent $332 billion on consumer goods and services and the gross fixed capital formation by business during the decade amounted to $100 billion, out of which $40 billion was spent on new machinery and equipment. There has been not only an impressive increase in production of goods and services, but perhaps even more important, an uneven growth in the different sectors of the economy and significant shifts in production. Automation, introduction of new products, new synthetic materials, new production and merchandising methods demanding large additional capital outlays have increased the strain on management to meet the needs of today and prepare for an even more rapidly changing tomorrow.

Forces for Business Combinations

Need for innovation, capital, market expansion and cost sharing were the forces which drew enterprises together. Accelerated rate of change resulted in accelerated rate of merging interests.

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4 Source DBS Daily - November 21, 1969: Gross National Product, Third Quarter 1969 - Advance Information: GNP of $78.7 billion, seasonally adjusted at annual rates.

The acceptance of sustained economic growth as an important objective for the economy required individual companies to review their ability to become aligned with the forces and trends underlying economic growth patterns. Some companies came to the realization that they themselves passed the period of vigorous innovation and expansion. They were still engaged in profitable, but now mature industries, with growth prospects below the economy's set standards. Cash flow was good but re-investment was unnecessary or undesirable. Such companies had the option to distribute the cash in the form of dividends or to seek outlets for their accumulated cash in new ventures or emerging companies as a means of widening their base of operations and so strive for growth.

At the same time, the 1960's provided a favourable economic climate for new companies to emerge and expand with the newly created and expanding markets for their products. Electronics and plastics are cases in point. However limited access to additional capital often frustrated small companies in their desire to further expand their operations.

The size of the Canadian markets sometimes precluded companies with limited product lines from achieving sufficient size to warrant application of some of the more advanced and sophisticated management and operational methods (computers, communication, accounting and cost accounting methods) and to compete successfully with foreign companies. There was also the desire to build operational and financial strength on a wider basis, less vulnerable to cyclical and one-product company malaise.

The restricted access to capital by small companies and the expected benefits derived from economics of scale

encouraged companies to pool resources.

Larger economic units have provided the needed challenge and expanding opportunities to new dynamic managerial groups. The specialized "talent bank" composed of financial, legal and industrial consultants promised dynamic internal growth and a "cross-fertilization" process to arrive at the optimum use of all corporate resources: cash, securities, borrowing power, real estate, capital mobility, legal and managerial advice.

Financing Acquisitions

Funds generated internally, however, were not satisfying the companies' demands for contemplated external or internal expansion. Corporations were turning to outside sources of funds with increasing frequency and found receptive investors. In the expansionary economy of the 1960's, Canadians have kept a relatively steady rate of savings, above the average of most other countries. While in the 1950's Canadians were saving at a high rate through purchases of insurance policies and buying fixed income securities, to a large extent in the 1960's they started to look for other investment alternatives in order to plan for their financial future. With the realization that the purchasing power of the Canadian dollar was slowly being eroded from $1.00 in 1961 to $0.78 in 1969, investors started to look for a hedge against inflation. Mutual funds have offered to an increasing number of people the desired alternative: to share, through investment in such funds, in the country's economic growth. Annual sales of mutual fund shares quadrupled between 1962 and 1968 and the net cash received over the seven-year period totalled $1.7 billion. The total net assets of the open-end funds grew from $941

million in 1960 to $3,463 million in 1968[5]. Other institutional investors, disenchanted with the bond market were also prepared to invest an increasing portion of their assets in equities and so to counteract the increasing competition from mutual funds, which started seriously to cut into the savings "pie".

The continuous prosperity encouraged an accumulation of funds in the hands of institutional investors. The equity market became a sellers' market. Institutional and individual investors were looking for more new issues. Private placements of convertible debentures or equities were becoming increasingly attractive to the institutional investors and the companies seeking new funds.

The prolonged prosperity allowed many small private enterprises to start, flourish and grow. However, many of these reached the point where funds for further steps in their expansion had to come from sources other than bank loans, mortgage money and accumulated profits. The alternative was to go to the public for funds through a public offering or to merge with another enterprise which had access to the money markets. The expense of public offerings for many prosperous small companies was out of the question. Private financing or merger was for many the only avenue leading to the realization of planned expansion. Prosperity and increased merger activity made a perfect combination.

Investor Interest in Acquisition-Minded Companies

The investors were attracted to companies which were searching for new and more imaginative ways to expand

5 Report of the Canadian Committee on Mutual Funds and Investment Contracts. Provincial and Federal Study, 1969, Ottawa, Queen's Printer.

through mergers and acquisitions, especially companies producing goods for which the markets were just opening.

The creativity of the management groups has concentrated not only on the full utilization of available internal resources for further growth. These groups were conscious that to the investor the historical performance of the company was never a satisfactory basis for projecting future performances. Management's eagerness to perform for the investor required management to seek ways which would accelerate the rate of past performances, namely, through future mergers and acquisitions.

Early acquisitions of profitable and well-managed companies or of companies with unrealized potential the securities of which were available at bargain prices increased the acquiror's growth above the average growth of the economy. In the U.S.A. one merger-oriented company, for example, reported a 110% five-year average annual sales growth, while the industry median was 19.1%. It was not unusual to find a five-year average annual earnings per share increase of 20 - 100 per cent, as compared to the industry median of 12.4%[6]. As more companies decided to grow via the merger route, first class companies or "sleeping beauties" with treasure chests full of liquid assets or undervalued real estate (easily converted into cash for future acquisitions) were harder to find or the prices for such companies were rising sharply.

In the U.S.A. according to a survey done by W.T. Grimm & Co.[7], acquirors paid for acquired companies an

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6 "Yardsticks of Management Performance, Multi-Industry", Forbes, January 1970, p. 96-104.

7 1968 Merger Summary by W.T. Grimm & Co., Financial Consultants, Specialists in Corporate Acquisitions, 135 Lasalle Street, Chicago.

average of 16.5 times earnings in 1966, 17.6 times in 1967, 24.6 times in 1968 and 21.5 in 1969. It is interesting to note that in 1966, when companies paid an average P/E ratio of 16.5, 60% of the transactions were for cash. In 1969, 57% of all acquisitions were made using shares. Incentive transactions (debentures and preferred shares with conversion privileges) became increasingly popular in the period from 1967 to 1969, (114 in 1967, 305 in 1968 and 728 in 1969). A rising stock market (until May '69), shortage of cash, high interest rates and higher prices demanded by acquiring companies were the underlying factors responsible for a shift to the greater use of equity shares in acquisition transactions. In Canada, according to the findings of the Joint Study[8] cash, and cash and share combinations accounted for the majority of the transactions.

Companies, committed to their "growth pattern" had to continue searching for ways to retain or improve the pattern or fall into disfavour with the investor. Investors bought shares of merger-oriented companies for their vigour, imagination, aggressiveness. The companies accordingly had to maintain the image investors gave them. They slowly found themselves trapped in their own gilded cage of success.

Top performers are always in the limelight and under the constant watchful eye of the public. There is a period in the life of a rising star where the public will allow itself to be carried away by excitement. However, the performer's success will continue only if the performer's talent and quality stand out after the novelty has worn off.

The authorities, financial press, and the investing public began to require more information than simply the

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8 See para. 1.06 of this Report.

company's overall growth pattern. They wanted to know also how this growth had been achieved, what percentage was due to internal growth, how much of it was attributable to acquisitions, whether the rate of growth could be expected to continue, and how effectively management would be able to digest acquisitions into an economically integrated system. In the past four years when the stock market has followed a steady rise and there was little concern about a decline, the financial analysis was reduced in many cases to observing one figure, namely earnings per share. This index was an easy analytical tool for many investment analysts and the investing public. Management of merger-oriented companies was quick to realize this reliance upon earnings per share. Improved earnings per share could be achieved either through internal growth (this road is relatively slow), or through acquisitions, especially of companies with a lower price/earnings ratio. Growth based on acquisition has, however, many inherent problems. The time when the authorities and the investing public started to pay close attention to the merger-oriented companies coincided with the time when internal problems were demanding increasing attention from the management group. The challenges encountered by such companies are now exposed to the public and the management groups are judged not only on their skill to acquire but equally on their ability to generate satisfactory internal growth.

Merger Oriented Companies at present

Merger oriented companies are facing serious challenges. With this accelerated pace of change they were able to grow rapidly because they introduced a fascinating new form of organization - the conglomerate - into a society

eager for change. The pace of change which brought them in, is also the force which continuously threatens them. The fear of remaining stagnant forced acquisition of some unprofitable companies which had low earnings per share ratios, usually well justified. Such acquisitions became such a burden that no "talent bank" could turn them into profit-making operations. Some companies, afraid of being acquired, entered defensive mergers. This escape from the frying pan landed them into the fire of challenges they had no way of coping with efficiently. Some mergers only accentuated structural or management defects inherent in their organizations. The capital which was attracted in the last few years to merger-oriented companies is now not so readily available or is very costly at a time when it is much needed by these companies for the completion of their plans. This has not only caused companies to pause in their acquisition program, but in many cases necessitated disposition of assets often at depressed prices. In the U.S.A. these companies face more problems than Canadian companies because of size and number of acquisitions and they are also subject to the criticisms directed at economic concentration.

Some Canada-U.S. Differences in Business Acquisition Trend

Although the trend in merger activity in Canada follows the trend in the U.S., there are significant dissimilarities between the two countries. While in Canada the majority of mergers which were consummated in the sixties could be classed as horizontal or vertical mergers, in the U.S. companies hampered by the anti-trust legislation were acquiring firms in unrelated fields and so creating conglomerates. The number of conglomerate acquisitions in

Canada is not nearly so significant[9].

Different tax treatment of the cost of debt financing in the U.S. as opposed to Canada influenced the method of financing of acquisitions: in the U.S. interest on funded debt incurred for an acquisition of shares is deductible for tax purposes. This is not the case in Canada. Consequently, in the U.S. a large number of merger-oriented companies used debt financing with conversion privileges. It provided them with tax relief and at the same time gave the debt security holders the opportunity to convert debt into equity. Since companies were not required to report earnings per share on a fully diluted basis, the dilution effect was postponed until the time of conversion. However, this tax relief encouraged merger-oriented companies to build heavier debt structures than considered acceptable for industrial companies. In Canada, debt financing for acquisition purposes has not been used to any extent probably because no tax benefit was to be gained from such a transaction. Share or cash purchases or a combination of both were used to a much greater extent in merger negotiations than in the U.S.[10]

While in the U.S. the pooling of interest accounting method has been used with increasing frequency in the reporting of business acquisitions, little regard was paid to the guidelines set by the American Institute of Certified Public Accountants for the circumstances in which this method should be applied. In Canada, pooling of interest has been used only in a small fraction of merger transactions. In the years 1960-1968 only 5.2% of the companies pooled[11].

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9 Interim Report on Competition Policy, op. cit. at p. 212, Chart A-1.

10 Op. cit. footnote 8.

11 Report of Joint Study at p. 46.

Conglomerate expansions[12] accounted for 40% of the poolings. Over 50% of the poolings occurred in 1967 and 1968 (42% took place in 1968)[13]. In Canada therefore the great majority of acquisitions were accounted for as purchase of assets or shares. However, it has to be pointed out that in Canada accounting procedures allow considerable choice as to how to treat the goodwill which has been created through an acquisition. This choice inevitably creates a problem for the investors when attempting to make a meaningful comparison of a company's present financial statements with the past financial statements or financial statements of other companies in the industry.

There is another aspect of acquisitions where the Canadian situation differs from that in the U.S. Canadians are concerned as a matter of economic nationalism with the acquisition of Canadian companies by foreign corporations. This issue, of course, does not arise in the U.S.

The conglomerate controversy sweeping the U.S. has spilled over into Canada. While the Canadian merger-oriented companies benefitted from the investment attitude towards the American conglomerates in the years 1967 to early 1969, the shadow of present difficulties is also being cast over Canadian "multi-companies". The honeymoon between the conglomerates and the investment community is apparently over. A thorough analysis of companies for economic soundness is being done, perhaps with a more hostile eye than some of the companies warrant.

Dagmar Stafl

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12 Report of Joint Study at p. 42.

13 Id.

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APPENDIX V

Review of Private Placements

Section 7 of the Regulations to the Securities Act, 1966 requires both the vendor and his agent, if any, in a private placement under section 19(3) of the Act to file with the Commission within 30 days of the placement a form reporting the placement, Form 8. This is a review of such forms from May, 1967 to July, 1969.

From May 1st, 1967 to December 31st, 1967, 20 forms were filed; in 1968, 78 forms were filed; and from January 1st, 1969 to July 14th, 1969, 70 forms were filed, a total of 168. The private placement means of raising funds is apparently becoming more popular. The dollar amount of such placements follows a similar trend; approximately $47 million in 1967, $133 million in 1968 and $298 million to July in 1969. The total value of securities placed pursuant to section 19(3) of the Act in the period reviewed was $478 million. The breakdown between debt and equity shares placed privately by year is:

	Debt	Equity
1967	$ 47 million	$ 0.3 million
1968	83 million (12.5 convertible)	50 million
1969	48 million (4.3 convertible)	250 million
	$178 million	$300.3 million

In the period reviewed 1,374 prospective purchasers were approached, 537 of whom invested under section 19(3).

APPENDIX VI

Review of Section 59 Applications

Section 59 of the Securities Act, 1966 permits an interested party to apply to the Ontario Securities Commission for a ruling whether a proposed trade would be in the course of primary distribution to the public. Application can only be made where doubt exists whether the proposed trade would be a primary distribution to the public. The *Weekly Summary* published by the Commission sets out the rulings made by the Commission under section 59. The *Summaries* were reviewed for the period May 1st, 1967 to December 31st, 1969 and the following general breakdown of the rulings made:

(1) A total of 449 applications were made under section 59.

(2) Rulings were refused in 17; 1 was withdrawn; 1 rescinded a previous order; and in 1 no order was made. *

(3) In the case of 28 applications rulings were given that the proposed trade would be in the course of primary distribution to the public.

(4) The rulings on the remaining 399 applications break down as follows:

(a) In 281, the Commission ruled that the proposed trade would not be in the course of primary distribution to the public and was silent on the matter of resale;

(b) In a further 84 the Commission

* Information on 2 was not available

ruled that the proposed sale would not be in the course of primary distribution to the public but that any subsequent distribution would be in the course of primary distribution to the public, the 1-2 ruling;

(c) 15 were made pursuant to subsection (1a) of section 59, i.e. the proposed trade was deemed not to be primary distribution to the public; and

(d) In the final 19 the Commission ruled that the proposed trade would not be in the course of primary distribution to the public and that any resale also would not constitute primary distribution to the public.

The applications were also reviewed to determine how many were made for trades in connection with proposed business combinations or acquisitions. 94 were clearly in connection with business combinations and acquisitions[1]. The breakdown by year is:

	No. of Applications for Business Combinations and Acquisitions
1967	4
1968	37
1969	53

1 Another 17 applications may have been in relation to business combinations.

Not all of these applications could be studied in the time available. Accordingly, a sample was constructed from the 36 companies which made 69 applications involving business combinations and acquisitions from May, 1967 to April, 1969. For companies which made more than one application only the most recent application was included. The basic sample was therefore 36 applications (involving 45[2] business combinations or acquisitions) by 36 companies.

Data for the review of the applications was obtained basically from two sources: the Ontario Securities Commission files supplied to the Study and the Financial Post Survey of Industrials for the years, 1967, 1968 and 1969. Some data on acquirees which were small private companies operating in Ontario was obtained from the Companies Branch public search department, and other gaps were filled by reference to the Toronto Stock Exchange Monthly Review (mainly stock exchange listings).

Ruling Granted

The ruling granted in all of the applications which constitute the basic sample was that the proposed trade would not be in the course of a primary distribution to the public.

Characteristics of Acquiror

The 36 applicants were categorized in various ways. The acquirors studied were public companies: 22 were incorporated in Ontario; 10 were federally incorporated. Therefore only 4 acquirors in the sample were neither incorporated federally nor in Ontario.

Of these acquirors 6 were not listed on any stock exchange; 26 were listed on the Toronto Stock Exchange; of

2 One application may involve more than one acquisition.

the 26, 5 were listed on the Montreal Stock Exchange and 7 were also listed on the Canadian Stock Exchange. There were 5 other listings by the 26 on various exchanges across Canada and the U.S. Thus it would appear that a company issuing shares in connection with an acquisition is likely to be a public company listed on at least one exchange.

A limited[3] analysis was made of the financial structure of the acquiror companies in the sample. Applicants having debt issues (includes bonds, debentures and notes; excludes bank loans and mortgages) outstanding at the time of the application, or in many cases at the nearest available date, were classified according to the amount of debt which was outstanding. The results were:

Debt Outstanding	No. of Companies
$ 0	16
1 - 99,999	1
100,000 - 999,999	5
1,000,000 - 4,999,999	9
5,000,000 - 9,999,999	3
10,000,000 - and over	2

Slightly less than half the companies involved have no debt outstanding and the remainder have amounts varying from $1 to over $10,000,000, with the peak frequency occurring between $1,000,000 and $5,000,000. Equivalent data for most of the acquirees was unobtainable.

3 The financial data gathered with respect to the applicant companies should be viewed as a general guideline and absolute amounts not quoted. This is due mainly to the fact that financial statements as of the time of the application were in most cases omitted from the files, and the Financial Post Surveys give only a limited amount of financial information mainly as of the calendar year end.

The capital structure of the applicants was also categorized as follows: applicants having preferred and common share issues (authorized and outstanding) and those having common share issues only.

Authorized	
Preferred plus common	19
Common only	17
Outstanding	
Preferred plus common	15
Common only	21[4]

Characteristics of Acquiree

Of the 45 acquiree companies 24 were private companies; 13 were public companies and 10 could not be determined. The majority of acquirees (23) were incorporated in Ontario. 8 were federally incorporated and the others were spread across three provinces of Canada, Jamaica and the Bahamas. The acquirees were generally unlisted (29 had no listings), although 6 were listed on the T.S.E.

Type of Acquisition or Combination

Consideration of the type of acquisition or combination proposed in the application revealed that there were 38 instances of share purchases, 5 asset purchases and 2 purchases of both shares and assets. The consideration paid for these acquisitions is summarized in the following table.

	Consideration Paid			
Type of Merger	Cash Plus Shares	Shares	Cash	Unknown
(38) Purchase of Shares	16	18	2	2
(5) Purchase of Assets	4	1	-	-
(2) Purchase of Shares and Assets	1	1	-	-
(45)	21	20	2	2

4 This includes 4 companies with authorized preferred and common but with only common outstanding.

Number of Acquiree Shareholders

For the 30 cases where the actual number of persons to whom the shares were issued was available, the total number of persons was 132, giving an average of 4.4 persons. The maximum number of persons or companies taking shares from the acquiror was 16. The following is a frequency distribution of acquiree shareholders:

Number of Acquiree Shareholders	Number of Acquisitions
1	3
2	8
3	7
4	1
5	1
6	4
7	1
8	2
10	2

Diversification

For the sample of 36 applicants the transactions were categorized according to whether the company appeared to be diversifying its interests or on the other hand merely expanding an existing class of its business. Results were as follows:

Diversification	10	
Expansion	18	
Unknown	8	(no data for one company or other)
	36	

APPENDIX VII

REVIEW OF TAKE-OVER BIDS

"Take-over bids" as defined in section 80 of The Securities Act, 1966 are regulated by Part IX of the Act. Section 56 of the Regulations to the Act requires every offeror who makes a take-over bid to file a copy of the bid and all supporting or supplementary material with the Ontario Securities Commission.

In the period from May 1st, 1967 when Part IX came into force, to December 31st, 1969, 87 take-over bid circulars have been filed. This is a review of these circulars to determine such matters as the characteristics of the offerors, common terms of take-over bids, the financing of the acquisition, the reaction of the offeree company and the success or failure of the bids.

Offeror Place of Incorporation

Of the 80 offerors analysed under this heading 17 were federally incorporated, 17 were incorporated in the U.S. and 46 were provincially incorporated, of which 28 were incorporated in Ontario. These figures may not be entirely accurate as in some instances the place of incorporation was not available and was therefore assumed to be the same as the incorporating jurisdiction in which the head office was located.

Frequency of Take-over Bids

The frequency was determined on a monthly basis. The greatest number of offers in one month was 5 (in August and October of 1967, November of 1968 and in April and May of 1969). The frequency of bids on a quarterly basis is

shown in the following table:

TABLE 1 - Frequency of Take-over Bids

	1967	1968	1969
1st Quarter	-	4	10
2nd Quarter	1	10	12
3rd Quarter	9	7	6
4th Quarter	10	11	7
	20	32	35

Initial Offer Period

The minimum period of time during which a take-over bid may be open is 21 days (clause 1 of section 81). The number of days during which bids were open is disclosed in the following table:

TABLE 2 - Number of Days in Initial Offer Period *

No. of days	21	22	23-29	30-35	36-99	100 Plus	Total
No. of offers	9	11	21	24	8	13	86

* Because a number of offers have not yet been completed the following statistics should only be used as an approximation.

Many offeror companies stated in their circulars that the initial offer was subject to extension. 11% (10) of the offerors extended their initial offer period for periods ranging from 10 to 160 days.

Percentage of Offeree Shares for which Bid made

6 unconditional bids were made for all of the class of equity shares of the offeree outstanding.

A frequency distribution for 79 bids[1] was made of the percentage of shares in the offeree company which the offeror sought in the take-over bid (minus the amount of shares which the offeror already owned before the beginning of the offer period[2].) This distribution is set out in Table 3(a). Another distribution was prepared of the total percentage of shares which the offeror would hold if the offer was successful[3]. The latter distribution is set out in Table 3(b).

TABLE 3(a) - Percentage of Shares in Offeree Company for which bid is made

	10%	11-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	91-100%
Number of Companies	6	3	8	8	12	7	10	6	12	7

TABLE 3(b) - Total Percentage of Shares in Offeree Company held by Offeror if offer succeeds.

	10%	11-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	91-100%
Number of Companies	-	2	2	1	8	12	11	5	16	22

1 A "triple bid" made by one of the offerors was difficult to qualify in a single percentage term until it was discovered that the offeror eventually hoped to hold all the outstanding stock of the three offeree companies except for minority interests consisting of stock options or warrants and those held by subsidiaries of the offeree. Therefore, in order to include this bid in the table it was placed in the 91-100% category of shares to be purchased by the offeror company.

2 Item 1 of section 90 requires the offeror to disclose his existing investment in the offeree company at the time of making the bid.

3 This figure includes both the percentage of offeree shares the offeror holds before the offer plus the percentage of shares the offeror would like to obtain through the bid.

These two distributions are set against each other in Table 4.

TABLE 4 - Percentage of Shares in Offeree Company for which Bid is made

		10%	11-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	91-100%
Total	10%										
Percen-	11-20%		2								
tage of	21-30%			2							
shares in	31-40%				1						
offeree	41-50%			1		7					
company	51-60%	1*			2	3	6				
held by	61-70%				1	1	1	8			
offeror	71-80%								5		
if offer	81-90%	1		1	2					12	
succeeds	91-100%	4	1	4	2	1		2	1		7

These tables are best explained by example. In Table 4 it can be seen that there was one company (with the asterisk) which sought to purchase less than 10% of the equity of the offeree company, and which would hold between 51-60% if its offer was successful. The companies along the diagonal line in the table were those which held 10% or less of the offeree's shares before the bid, i.e. if the bid succeeded the offeror's holdings in the offeree would be the percentage in the offeree for which the bid was made plus 10% or less (its existing investment in the offeree). Those companies beneath the diagonal held more than 10% of the offeree's shares before making the take-over bid. It is apparent that although only 7 companies bid for more than 90% of the outstanding shares of the offeree company (and probably were thinking of using section 128 of the Canada Corporations Act or the provincial equivalent to confiscate the remaining

shares), 22 companies were in a position to obtain that amount when the shares they already owned were taken into account. A similar trend could be seen in the number of shares that were to be purchased to gain control juxtaposed with the number of shares the offeror company would have after the completion of the offer. 37 companies bid for less than 50% of the outstanding shares of the offeree company, yet only 13 companies would actually hold less than 50% if their offer was successful. An offeree determining whether an offeror is seeking actual control must put together what the offeror is seeking and what he already owns[4].

Offeror Investment in Offeree Prior to Bid

In approximately 37% of the offers, the offeror already held some percentage of the offeree's shares; in 50% of these the offeror already held over 50% of the class of the offeree's shares before making the offer. 97% of the offerors who held some part of the offeree's shares made a bid to obtain actual control, i.e. more than 50% of offeree's shares, and 56% hoped to be able to purchase 90% or more of the total shares of the offeree (those companies on the bottom and next to bottom diagonal in Table 5 below). In 55 bids the offeror did not own any of the offeree's shares prior to making the bid.

4 In cases where two or more classes of shares were sought only common shares were considered. In addition to all the shares that an offeror might obtain before the bid and from the bid an offeror can purchase in the market while his offer is outstanding. Consequently the 13 offerors which did not in this analysis gain actual control through the bid over the offeree could still buy additional shares in the market to achieve actual control. Note that 8 out of the 13 needed 10% or less to achieve this position.

TABLE 5 - Frequency Distribution

Percentage of Shares in Offeree owned by Offeror at time of making bid.

		10%	11-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	91-100%
Percen-	10%									3	3
tage of	11-20%								1	1	
shares in	21-30%	1	1	1				2	2		
Offeree	31-40%		1	2		1	1	2			
which	41-50%	3		1			1				
Offeror	51-60%	2									
seeks in	61-70%				2						
bid *	71-80%	1									
	81-90%										
	91-100%										

* (exclusive of holdings in offeree at time of bid)

Classes of Offeree Shares for which Bid made

The offers made for only common shares of the offeree company were by far the most prevalent - almost 84% of the total offers (73 in number). 9 more offers were made for both common shares and either preferred shares or warrants of the offeree and the remaining offers were for a particular type of share, such as a voting trust certificate.

Consideration Offered

The consideration offered by the offeror to the offerees can be broken down into three categories. *

TABLE 6 - Consideration Offered

Type of Offer	No. of Offers	% of Offers
Cash only	47	54%
Shares	28	32%
Cash and Shares	10	12%
Choice of either cash or shares	1	1%

* Data on one bid was not available

Identity of Offeror

If the offeror offers cash consideration the Act does not require him to disclose his identity. In three of the 47 offers of cash the identity of the offeror was not disclosed. This includes however one offeror which was partly disclosed: the offerors were 4 people (disclosed) and a limited company (not disclosed). The other two offers were made through an intermediary, i.e. a trust company.

Directors' Circulars

Section 86(1) of the Act requires directors of the offeree to send a directors' circular to shareholders of the offeree whenever the directors recommend acceptance or rejection of the bid. 47 directors' circulars were filed in response to the 87 bids studied. 35 recommended acceptance of the offer. Out of the 35 cases of favourable recommendations 20 of the bids were successful, 3 bids did not succeed and 12 offers were either not completed or for some other reason it was not possible to determine whether the bid was completed. 3 directors' circulars recommended rejection of the offer; 1 of the bids opposed was nevertheless successful. There were 9 directors' circulars sent out in which the directors stated that they would make no recommendations or were silent but in which they disclosed whether or not they personally would accept the offer pursuant to item 2 of section 95. 40 offeree companies did not send out a directors' circular and of these 23 were successful, 8 unsuccessful and 9 were indeterminable bids. The directors' circulars were correlated in Table 7 to determine whether the directors' circulars influenced the success or failure of the offer.

TABLE 7 - Directors' Circulars

Directors' Circular: Type of Recommendation	Success or Failure of Bid: Success	Failure	Not known	Total
Unanimously Recommend Acceptance	8	1	3	12
Recommend Acceptance	12	2	9	23
Recommend Rejection	1	2	-	3
No Recommendation	2	1	5	8
Did not send Circular	23	8	9	40
Triple Recommendation *	1	-	-	1

* In this case 2 of the 3 offeree companies sent out directors' circulars, one unanimously recommending acceptance and the other recommending acceptance.

Offers to Minority Shareholders

Control of a company may be obtained privately without making a take-over bid by negotiating with the controlling shareholder. Such shareholder may require the buyer to extend the same offer to the non-controlling shareholders of the offeree company. There were only 5 take-over bids in which it was stated that the controlling person(s) required the offeror to make an offer to the minority shareholders in the offeree company on the same terms as the offer to the controlling person(s). Absolute figures were difficult to establish because this particular fact is not always mentioned by the offeror because the Act does not require him to do so. There were 11 other offers in which it was disclosed in the circular that the offeror already owned 50% or more of the offeree or had agreements from the offerees to tender 50% of their shares. These are other cases in which the offeror demonstrated some concern for the minority shareholders.

Variation in Terms of Offer

It was difficult to make a conclusive analysis of the types of variations made in the terms of offers. Some variations are apparently not recorded with the Commission although such filing would seem to be envisaged by section 56(1) of O. Reg. 101/67 to the Act. It was found that 10 offeror companies extended their offer period and 3 increased the consideration offered.

Example of Accounting for a particular business acquisition on both the pooling of interests basis and purchase basis of accounting.

Assume the Acquiror Company is buying all of the shares of the Acquiree Company and issuing its own shares in exchange. (Although the example which follows is a share exchange, an assets purchase or an amalgamation could equally be accounted for by using the pooling method; the consolidated statements appearing later would be identical for all three modes of business acquisition.) The balance sheets of the companies prior to the acquisition are:

ACQUIROR COMPANY - Balance Sheet

Assets	$2,000	Liabilities		$1,000
		Shareholders' Equity		
		50 NPV shares	$500	
		Earned surplus	500	1,000
Total Assets	$2,000	Total Liabilities and Shareholders' Equity		$2,000

Book Value Acquiror Shares $20 per share

Market Value Acquiror Shares $50 per share

Earnings - $150 (current financial year)

Earnings per share - 150/50 -- $3

P/E ratio - 50/3 -- 16.67

ACQUIREE COMPANY - Balance Sheet

Assets	$1,000	Liabilities		$ 500
		Shareholders' Equity		
		50 NPV shares	$250	
		Earned surplus	250	500
Total Assets	$1,000	Total Liabilities and Shareholders' Equity		$1,000

Book Value Acquiree Shares $10 per share

Market Value Acquiree Shares $10 per share

Earnings - $100

Earnings per share - 100/50 -- $2

P/E ratio - 10/2 -- 5

The Acquiror Company acquires all of the outstanding shares of the Acquiree Company by issuing 20 of its authorized but unissued shares being a consideration of $1000 based on a market value of $50.00. It is apparent that the Acquiror is paying a premium for the shares of the Acquiree equal to the difference between the $1000 paid and the net book value of the assets of the Acquiree ($500) underlying the shares of the Acquiree. This indicates that the Acquiror considered that the assets of the Acquiree were undervalued, the value not accounted for usually being considered as goodwill. This premium or goodwill is an important factor in differing between the pooling and purchase methods. Note that the Acquiree assets have not been revalued by the Acquiror.

After the acquisition the unconsolidated balance sheet of the Acquiror Company, using the purchase method,

would appear as follows:

Purchase Method

ACQUIROR COMPANY - Balance Sheet (Unconsolidated)

Assets	$2,000	Liabilities		$1,000
Investment in 1000 Acquiree Company shares	1,000	Shareholders' Equity		
		50 NPV shares	$ 500	
		20 NPV shares (issued @ $50/sh)	1000	
		Earned surplus	500	2,000
	$3,000			$3,000

The balance sheet changed with the addition to the assets of the investment in the subsidiary (Acquiree) at $1000 at cost (market value of Acquiror Company's shares) and the addition to shareholders' equity of 20 NPV shares with a book value of $50 per share.

Using the pooling method the balance sheet would appear as follows:

Pooling Method

ACQUIREE COMPANY - Balance Sheet (Unconsolidated)

Assets	$2,000	Liabilities		$1,000
Investment in 250 Acquiree Company shares	250	Shareholders' Equity		
		50 NPV shares	$500	
		20 NPV shares	250	
		Earned surplus	500	1,250
	$2,250			$2,250

The assets using the pooling method have been increased by adding the investment in the Acquiree Company shares at the book value of such shares (rather than at cost) and by adding to the shareholders' equity 20 NPV shares with a book value of $12.50.

The consolidated statements would appear as follows:

Purchase Method

ACQUIROR COMPANY - Balance Sheet (Consolidated)

Assets	$3,000	Liabilities		$1,500
Goodwill	500	Shareholders' Equity		
		50 NPV shares	$ 500	
		20 NPV shares	1000	
		Earned surplus	500	2,000
	$3,500			$3,500

The consolidated statement using the purchase method is prepared by simply adding the assets of the companies and by adding the liabilities. To the assets is added the premium paid for the shares of the Acquiree Company. The shareholders' equity is increased by the 20 NPV shares, at cost equal to market, of the Acquiror issued for the shares of the Acquiree. Note that the earned surplus of the Acquiree is not carried forward to the Acquiror when using the purchase method.

Using the pooling method the consolidated statement will appear as follows:

Pooling Method

ACQUIREE COMPANY - Balance Sheet (Consolidated)

Assets	$3,000	Liabilities		$1,500
		Shareholders' Equity		
		50 NPV shares	$500	
		20 NPV shares	250	
		Earned surplus	750	1,500
	$3,000			$3,000

Absent, using the pooling method is the acquisition premium because the shareholders' equity of the Acquiror is simply increased by the book value of the assets underlying the Acquiree's shares. This involves carrying forward the Acquiree's earned surplus at the value it carried in the Acquiree's books and assigning a book value to the shares of the Acquiror issued for the shares of the Acquiree equal to the value of the Acquiree's shares as carried on the books of the Acquiree.